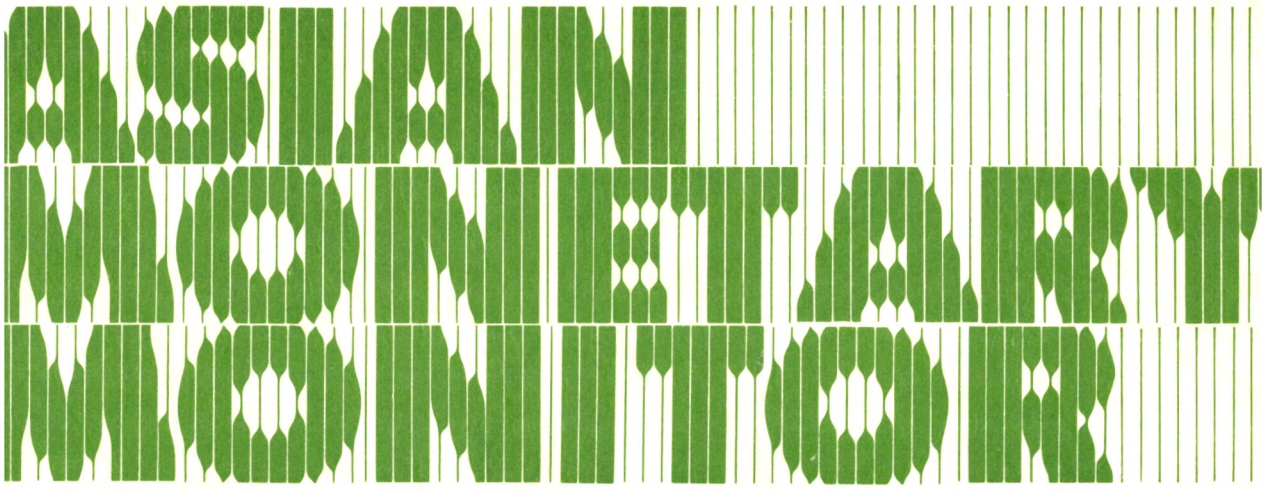
AMM January-February 1992 Vol. 16 No.1



CONTENTS

		Page
AUSTRALIA		
Factors Shaping the Recovery by Andrew Freris		1
TAIWAN		
Liquidity Management during the Next Expansion by John Greenwood		12
THAILAND		
Cyclical Adjustment is not yet Complete by Simon Ogus		26
ECONOMIC CAPSULES		
China: Mixed Economic News	AFF	36
New Zealand: The Reserve Bank Lets Go of the Currency	SLO	38
INDEX		
An Index of AMM Articles Published in Volume 15		40

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ASIAN MONETARY MONITOR

January - February 1992 **Vol. 16 No.1**

AUSTRALIA
FACTORS SHAPING THE RECOVERY

Introduction

On the 8th of January 1992 the Reserve Bank of Australia announced the eleventh reduction in interest rates since January 1990. A number of indicators now show that the economy is entering its recovery phase. Two important factors, however, other than the future movements of interest rates, will help to shape the path of this recovery.

In past cyclical upturns, such as those of 1983 and 1986, the current account deficit tended to widen. As economic growth accelerated the worsening external balance caused the authorities to restrict credit. This did happen in April 1988 and precipitated a monetary squeeze which lasted until January 1990, and which contributed to the current recession.

The public sector in Australia ran up a surplus during the 1988-89 fiscal year. Since then the overall position of the public sector has stayed in deficit and it is likely to remain so as the recession reduced the growth of tax revenues and increased expenditures such as unemployment benefits.

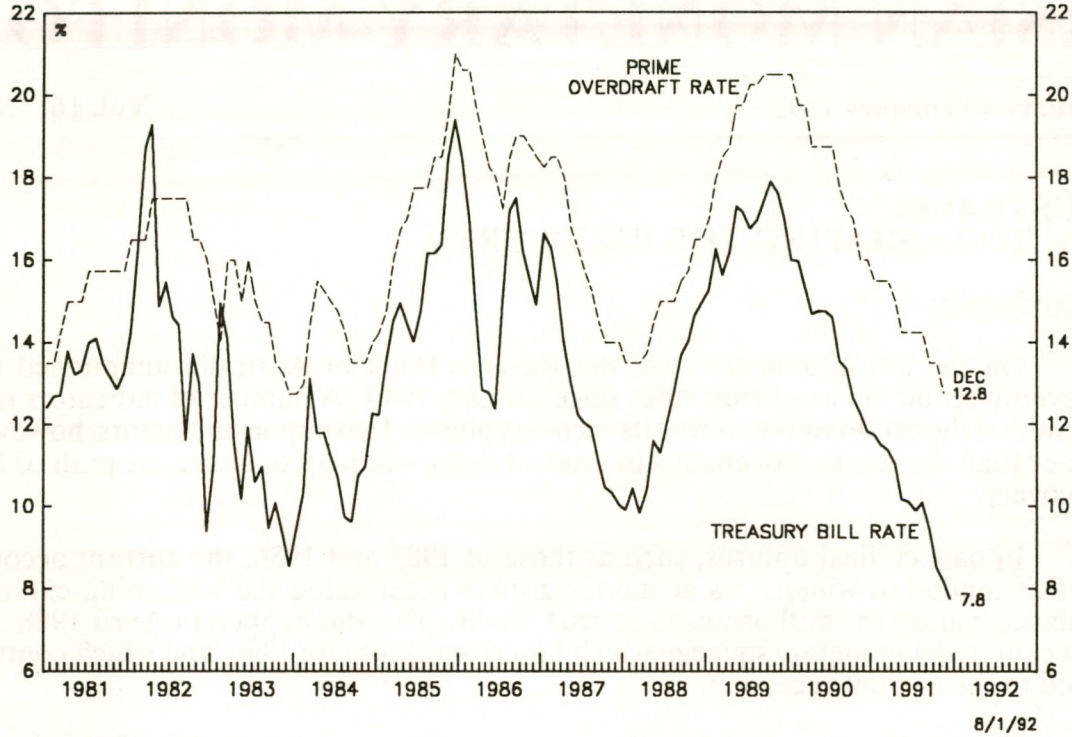
The promise of the new Prime Minister, Paul Keating, that the government will reconsider its fiscal stance could stall any further and significant cuts in interest rates, particularly as the Australian dollar weakened after the most recent interest cut. Also any adverse developments in the current account could force the authorities to reconsider their policies. Notwithstanding these caveats, the prospects for a healthy recovery remain good. Inflation rates are now the lowest in a decade, unemployment the highest since the war, and the abolition of centralised wage fixing augurs well for the control of inflationary pressures.

This article examines the monetary policy pursued so far in the context of the impact of interest rate cuts on the economy and on the prospects for the nascent recovery. Particular attention will be paid to the developments in the balance of payments, foreign exchange rate and the budget deficit.

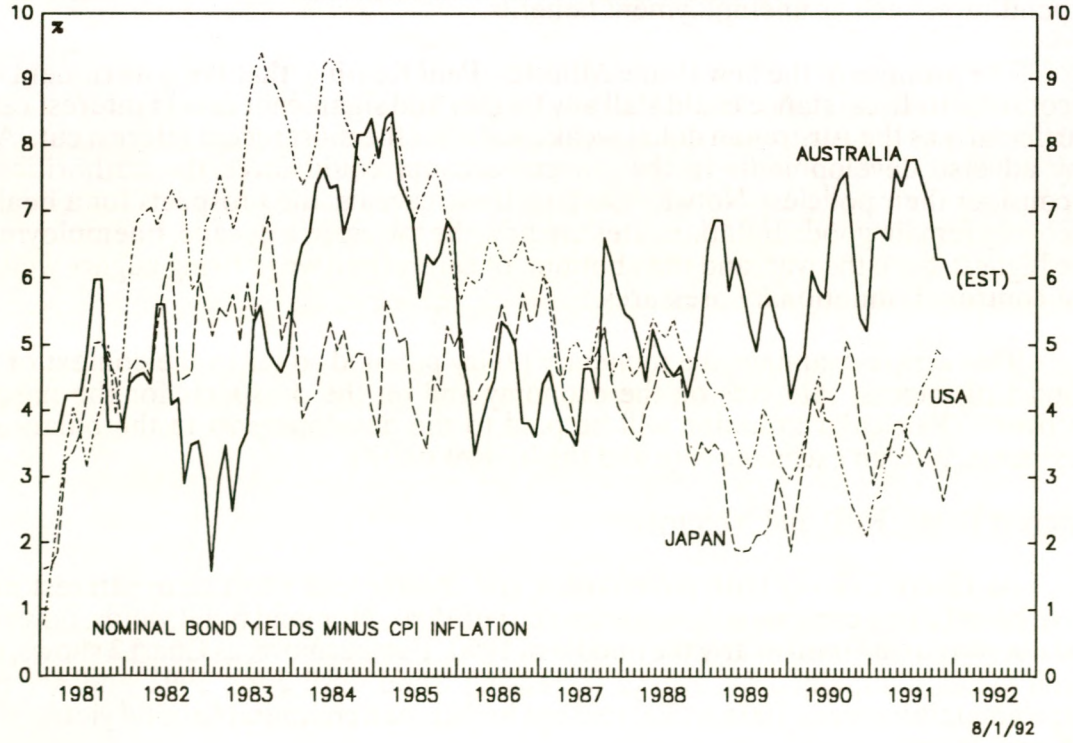
Interest Rates, Real and Nominal

As Chart 1 shows both government and commercial short term interest rates have been falling continuously since the start of 1990. Nominal bond yields, however, did not start to fall until nearly the middle of 1990. Furthermore, as Chart 2 shows, real bond yields maintained an overall increasing trend until June 1991 and are now approimately between 100 and 300 real bps higher than comparable bond yields in the US and Japan.

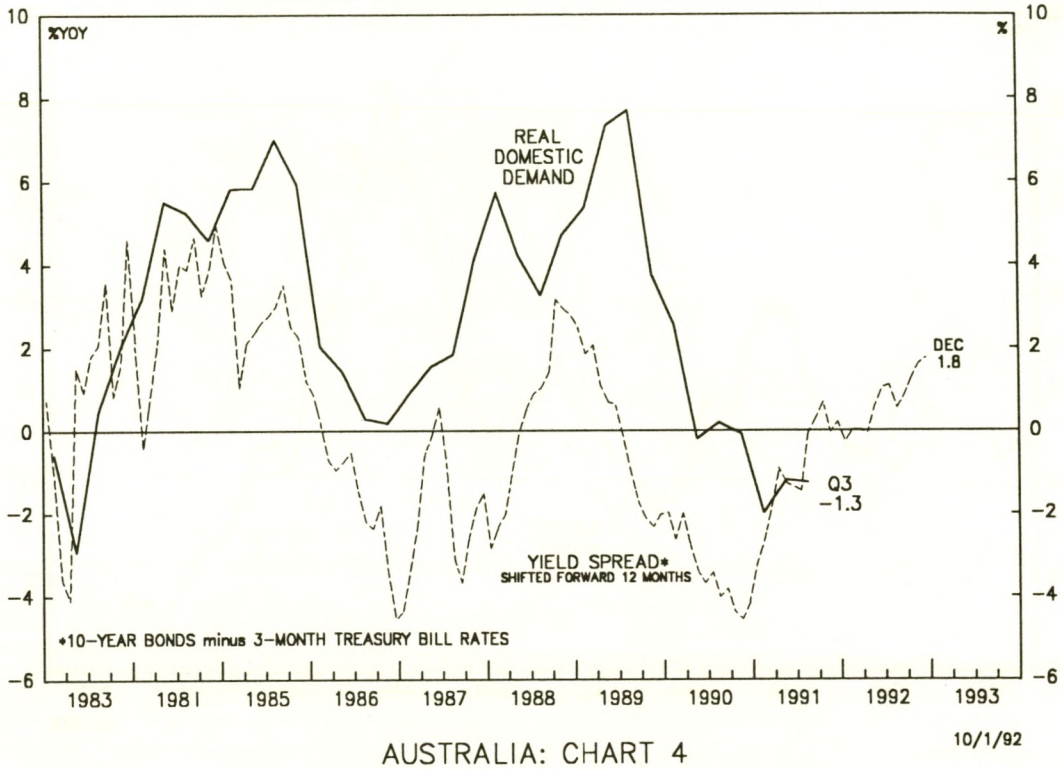
AUSTRALIA: CHART 1
SHORT TERM INTEREST RATES



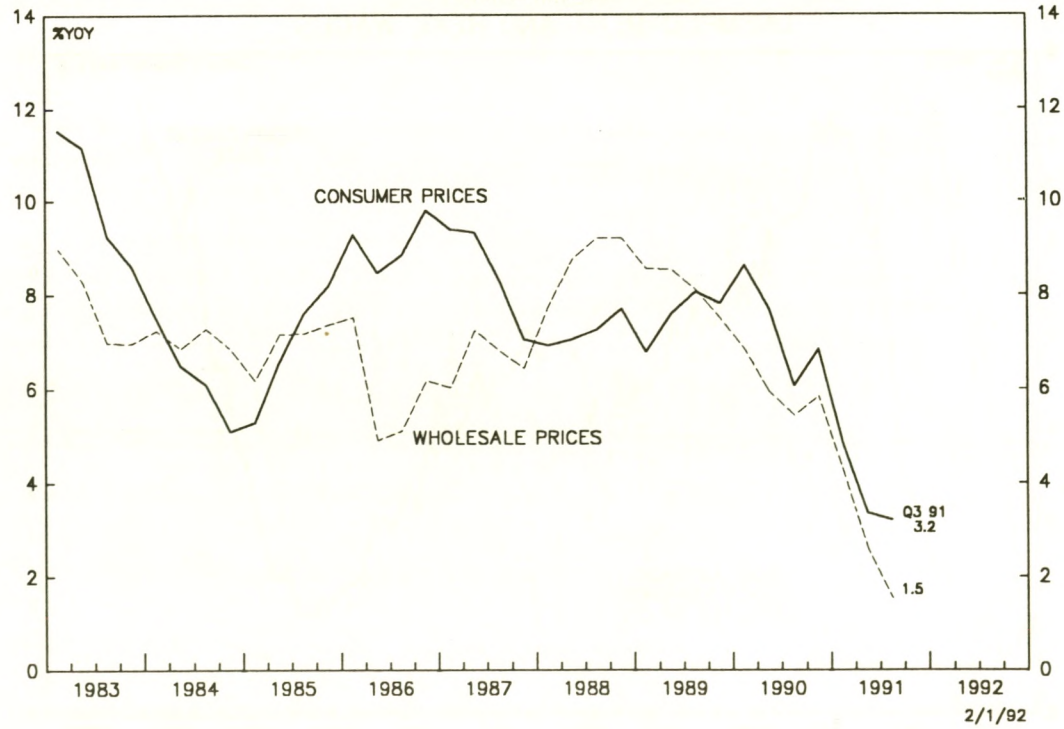
AUSTRALIA: CHART 2
COMPARABLE REAL BOND YIELDS



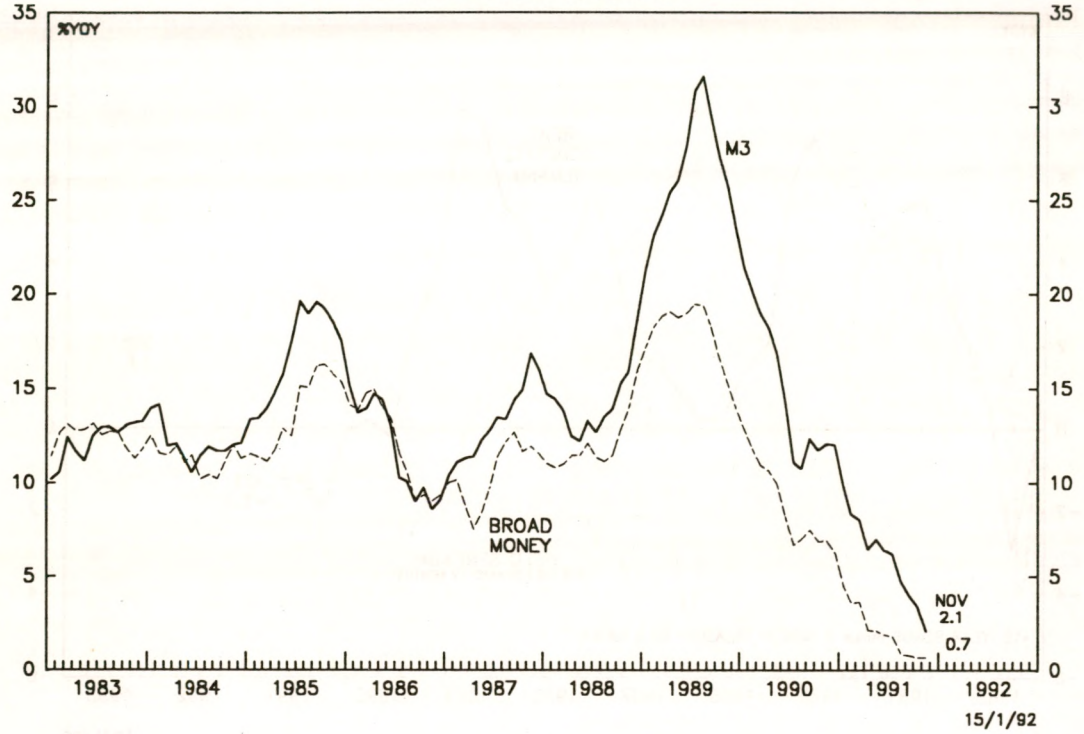
AUSTRALIA: CHART 3
DOMESTIC DEMAND AND THE YIELD SPREAD



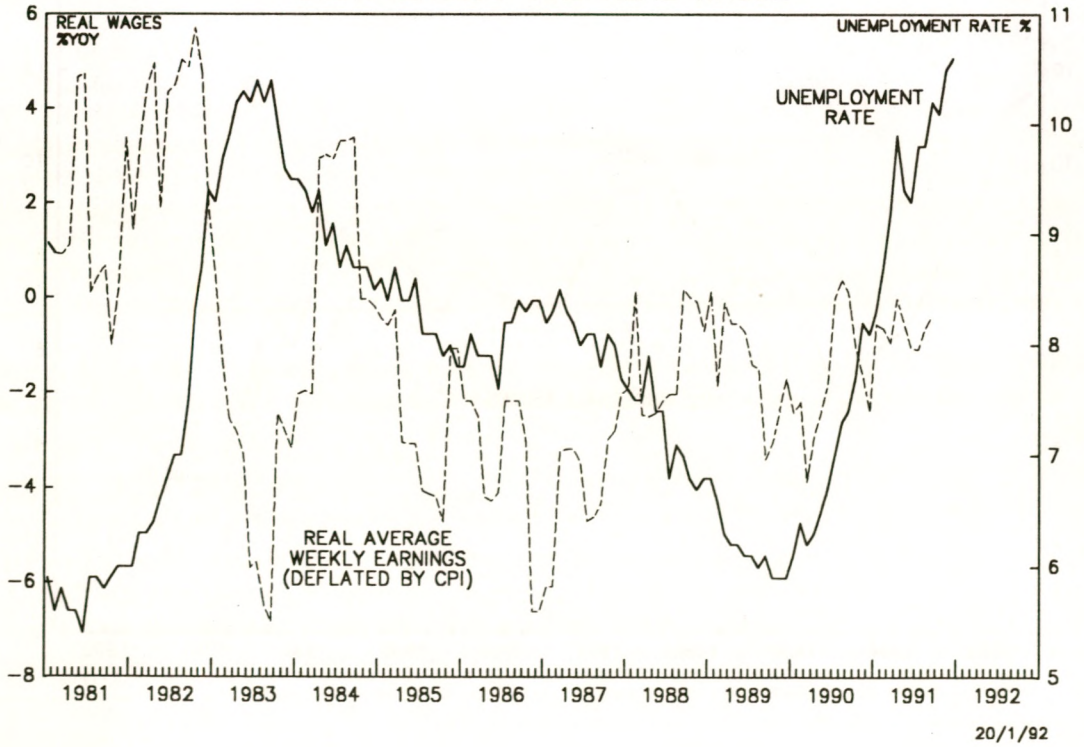
AUSTRALIA: CHART 4
INFLATION



AUSTRALIA: CHART 5
MONETARY GROWTH



AUSTRALIA: CHART 6
UNEMPLOYMENT AND REAL WAGES



The behaviour of the Australian real bond yields raises the question whether their current level and rate of decline are likely to slow down the recovery of the economy. In answering this question there are a number of important factors to be taken into consideration.

Firstly, past evidence on the recovery phases of the Australian economy indicates that the upturn in the rate of growth of the GDP had been compatible with both rising real bond yields, as in 1983, and rising and falling real bond yields as in 1986. It must be noted, however, that on both these occasions the absolute level of real yields was less than the present one.

Secondly, to the extent that the slope of the yield curve is a good indicator of the degree of looseness of monetary policy, the slope became zero and then positive within the first half of 1991 (see Chart 3, but note that the yield curve has been shifted one year forward). Given the lagged relationship between the growth of real aggregate demand and the impact of the looser monetary policy, the bottoming out in the growth of aggregate demand during 1991 Q3 will be, at worst, maintained and at best could move into positive territory during 1992 Q3.

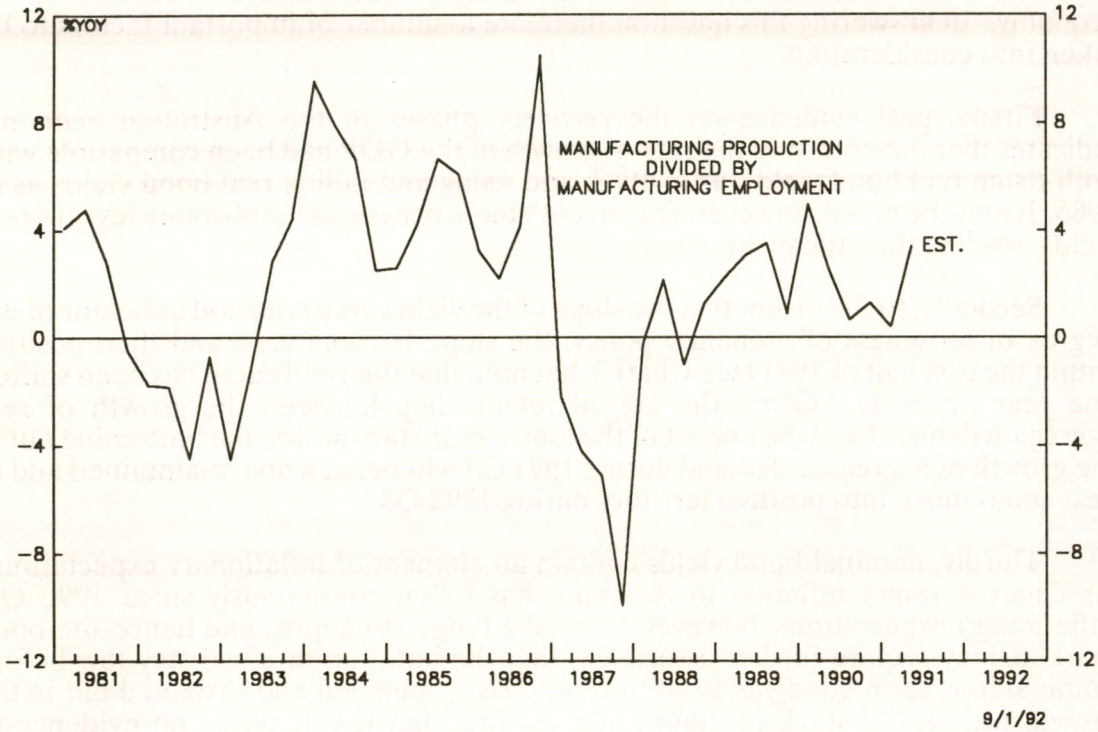
Thirdly, nominal bond yields contain an element of inflationary expectations. As Chart 4 shows inflation in Australia has fallen continuously since 1990 Q1. Inflationary expectations, however, may take longer to adjust, and hence the bond markets may require further assurances that the inflation rate will stay low before nominal long term bond yields fall further. The prolonged and sustained fall in the growth rate of the stock of money and the fact that it still shows no evidence of bottoming out, may be another factor that the bond markets will take into consideration in assessing any future adverse movement in the rate of inflation (Chart 5).

Fourthly, the probability of a wage explosion during the period of the recovery has considerably lessened. This should impact favourably on inflationary expectations and hence on bond yields. Furthermore in a period of potentially falling inflationary expectations, wage negotiation may enter a period of "virtuous cycle" particularly if, as will be presently shown, productivity deals become the norm in negotiations. The unemployment rate, which is a lagging indicator, stands at present at a post-war record level (Chart 6). Real wage growth in Australia has stayed at negative levels since 1985, during periods of centralised wage settlements and powerful trade unions. Indeed if real wage movements are pro-cyclical, that is they tend to rise during booms, then the 1986 recovery offers evidence of how a recovery can take place without an upswing in real wages. In the 1983 upswing, however, real wages did rise. The movements of nominal wages may well depend on the overall availability of credit. So, for example, during 1983 the rate of money growth rose steadily, but during 1986 the rate of growth fell.

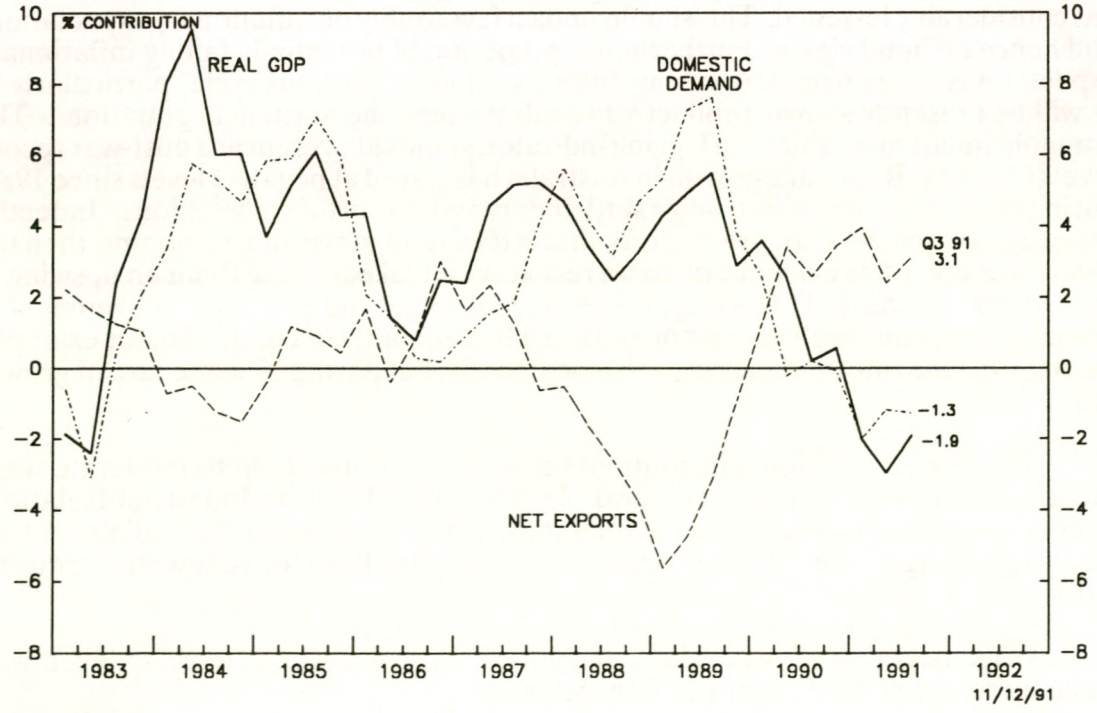
There is an additional institutional change which may help to moderate wage movements during the recovery phase. In November 1991 the Industrial Relations Commission (IRC), announced the final stage of the abolition of Australia's centralised wage fixing system. The reformed system will now have the following characteristics.

1. Wage negotiations will take place almost exclusively at enterprise level, with wage increases related to productivity gains.

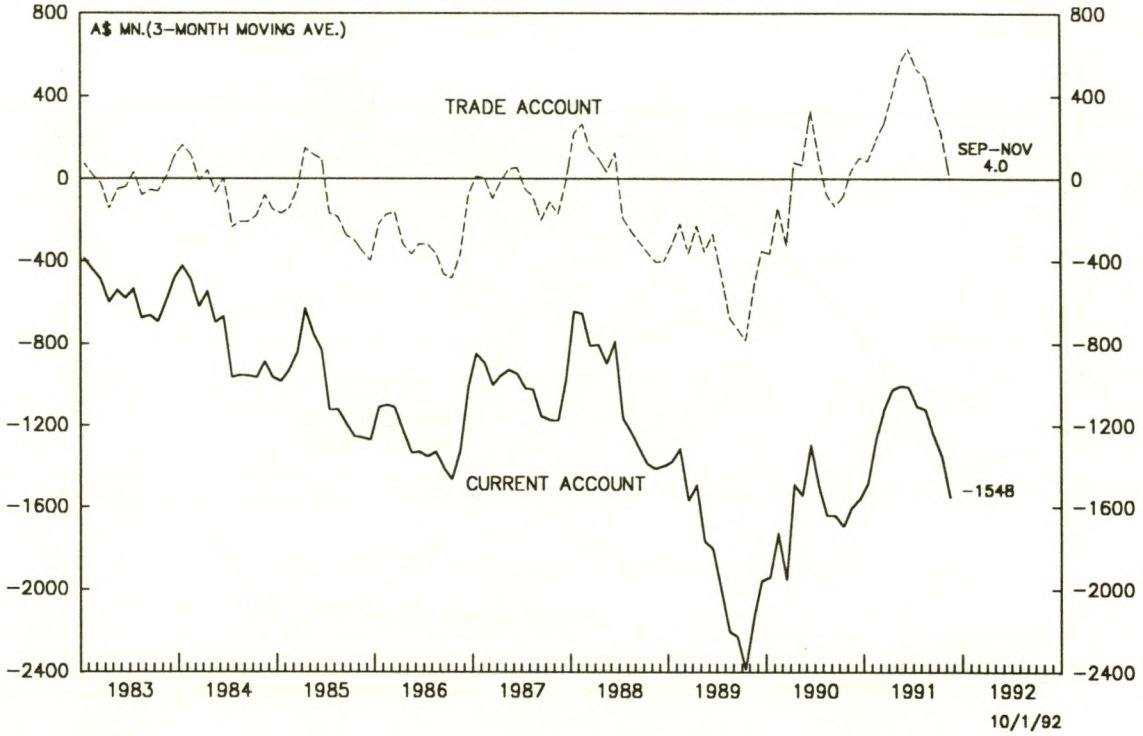
AUSTRALIA: CHART 7
INDEX OF LABOUR PRODUCTIVITY GROWTH



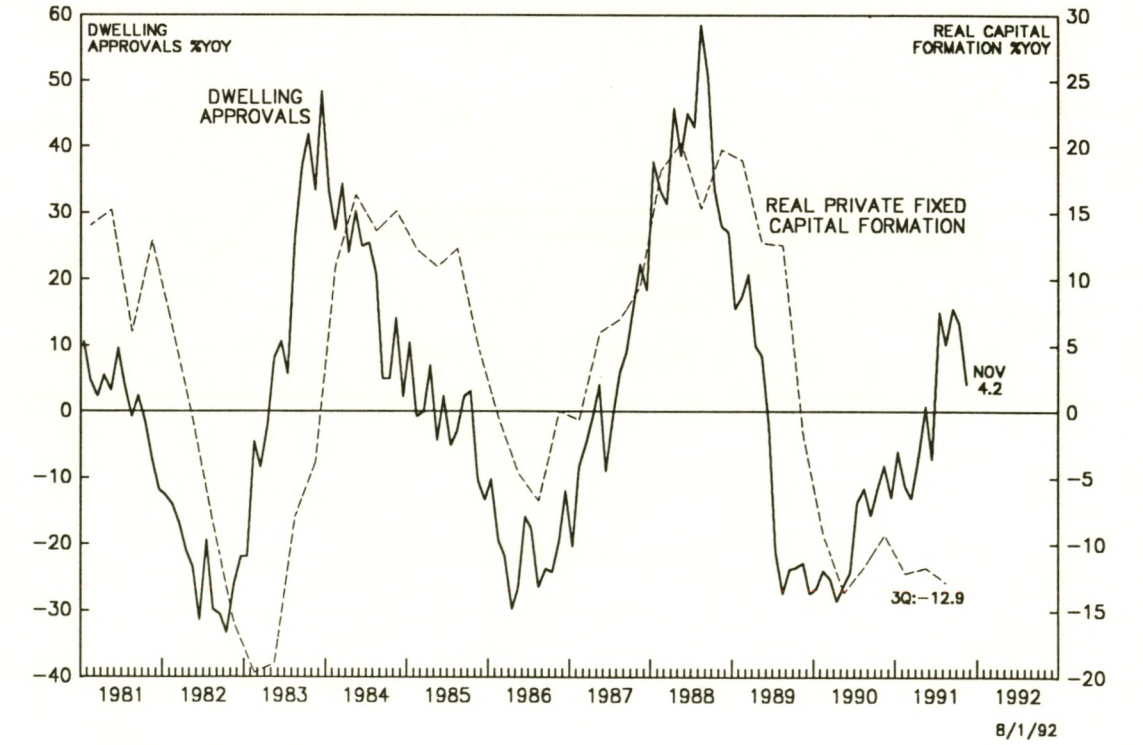
AUSTRALIA: CHART 8
CONTRIBUTION TO REAL GROWTH



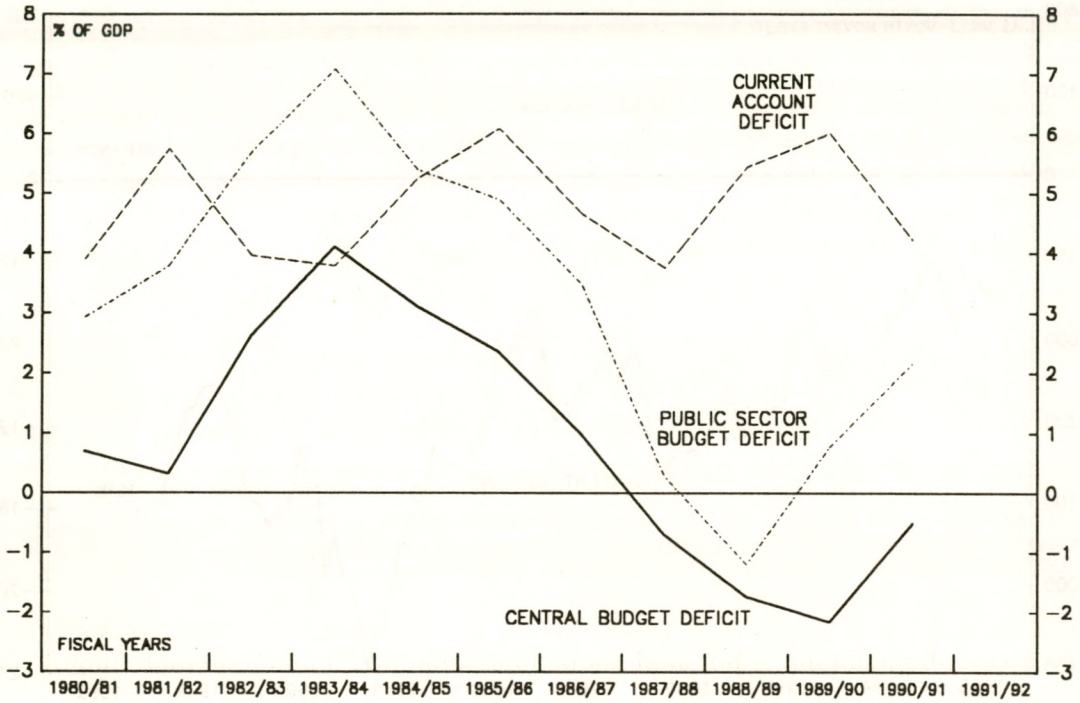
AUSTRALIA: CHART 9
TRADE AND CURRENT ACCOUNT



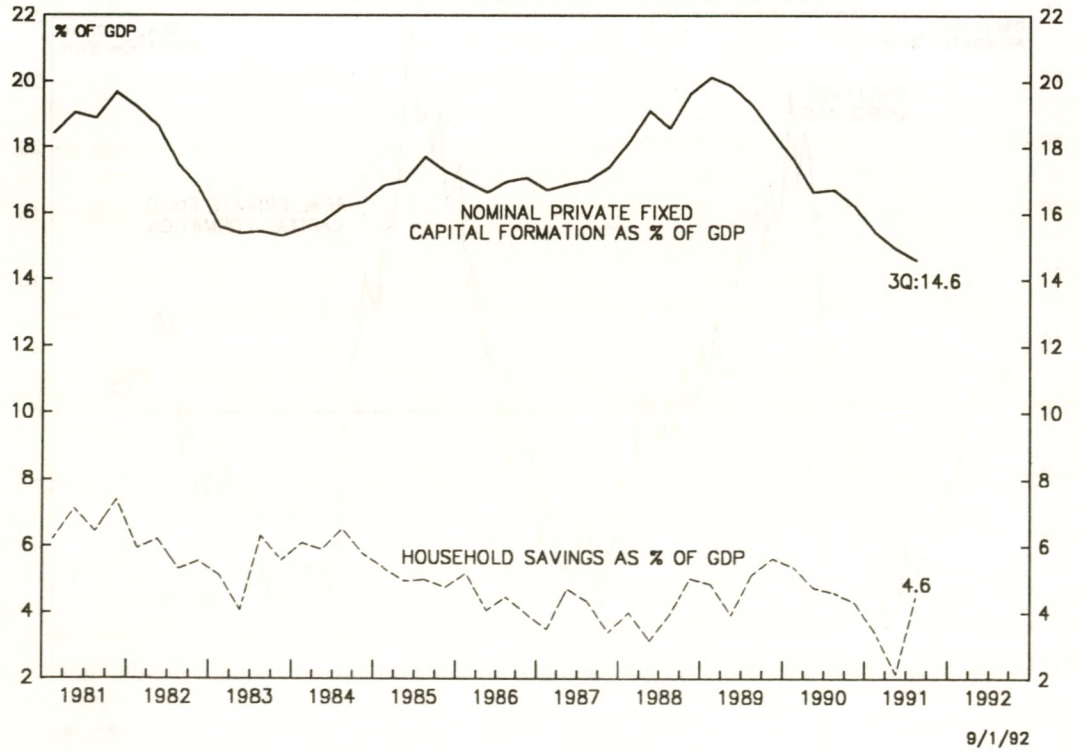
AUSTRALIA: CHART 10
INVESTMENT AND HOUSING EXPENDITURES



AUSTRALIA: CHART 11
PUBLIC SECTOR AND CURRENT ACCOUNT DEFICITS



AUSTRALIA: CHART 12
SAVINGS AND INVESTMENT AS % OF GDP



2. Negotiations at enterprise level must cover all the unions concerned, the agreements will be for a fixed period, and strikes to vary the terms of a negotiated agreement will not be permitted.

3. The IRC will conciliate in disputes but will not arbitrate. A "national wage" will still be established, but its adjustments will take place periodically and are expected to be very modest.

Decentralisation of wage bargaining is no guarantee of industrial peace. However if a strong trade union did extract wage increases unrelated to productivity, this would only benefit its members in that particular enterprise with no further national or sectoral repurcussions.

Since 1988 labour productivity growth made rapid gains (Chart 7). The recovery phases of 1983 and 1986 were both associated with rising productivity rates and the estimates for 1991 H.1 remain very encouraging. Labour productivity gains can therefore be expected to temper any "surge" in nominal wage settlements during 1992.

In summary, despite the present comparatively high levels of real interest rates, there is a considerable amount of evidence in favour of falling inflationary expectations and hence of further falls in nominal long term bond yields. Recovery phases in Australia have been associated with both rising and falling real interest rates. In the current phase real rates are falling and the positive slope of the yield curve points to an easier monetary policy. Finally, there is no immediate danger of a wage "break out" which could impact on inflation given the high unemployment rate, positive labour productivity growth and absence of evidence of an upturn in the growth of money stock.

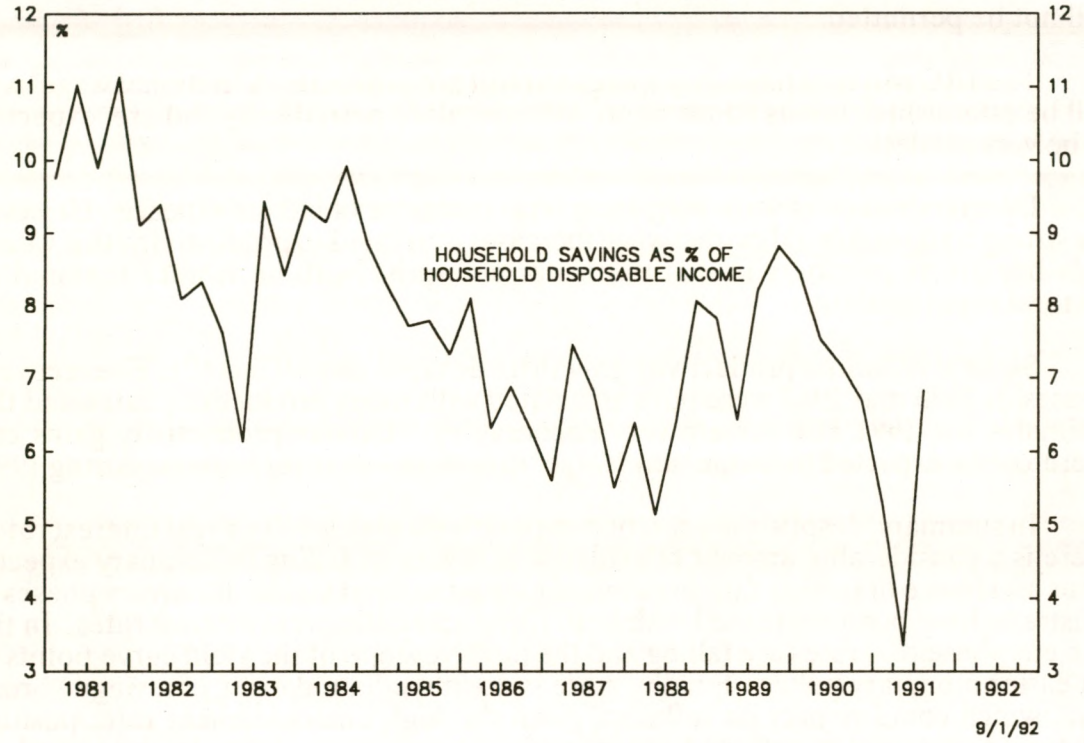
Recovery and the Deficits

Chart 8 shows that the negative growth of GDP appears to have bottomed out in 1991 Q2. The negative contribution of domestic demand to the growth of the GDP on a year-on-year basis seems to have been arrested during the next quarter. The positive contribution of the trade surplus will, however, begin to weaken since the absolute level of the surplus has been declining since June 1991, and almost disappeared towards the end of the year (Chart 9).

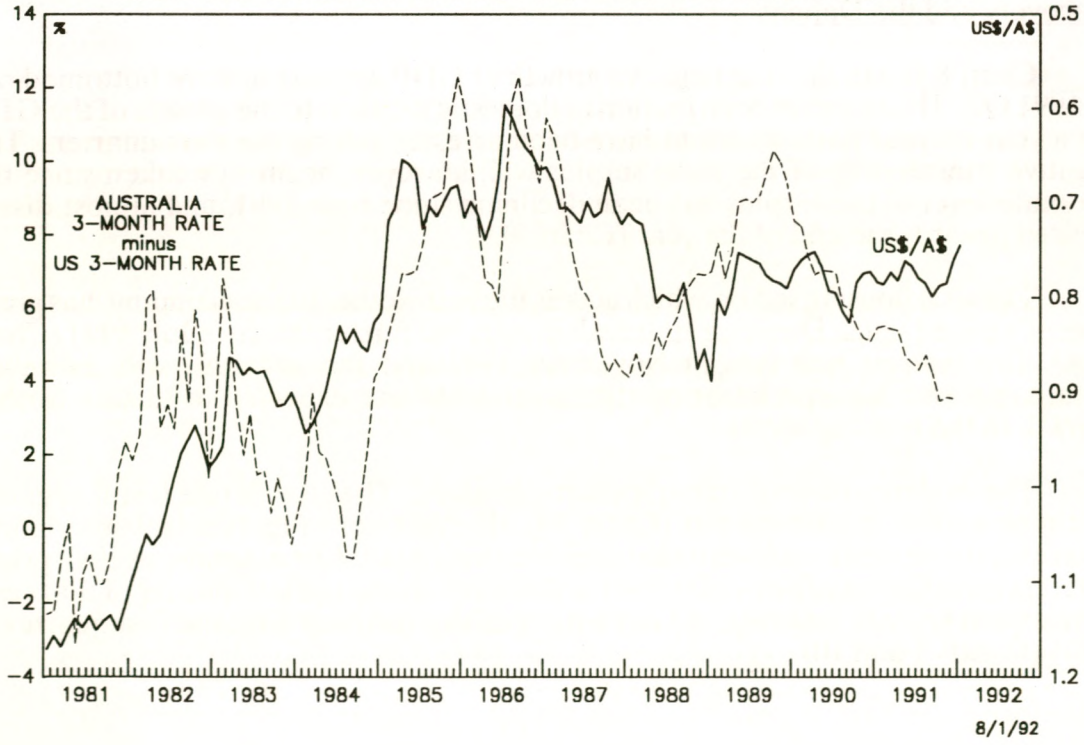
The vital housing sector, which acts as the bell-wether of the economy, has given recently mixed signs. Dwelling approvals growth has fluctuated since July 1991 (Chart 10). The interest rate cuts of November 1991 and January 1992 will, however, translate with a lag into lower mortgage rates and are expected to sustain further growth in the housing sector.

The evidence on investment spending is mixed. The growth rate is still negative but may well be bottoming out (Chart 10). Furthermore the deceases in nominal interest rates operate on investment decisions with a lag. For example, in 1982 prime interest rates flattened out and started to decrease during the last quarter of that year. Investment growth, however, did not enter positive territory until the first quarter of 1984 (Charts 1 and 10).

AUSTRALIA: CHART 13
SAVINGS AS % OF INCOME



AUSTRALIA: CHART 14
RELATIVE INTEREST RATES AND THE AUSTRALIAN DOLLAR



As the introductory comments in this article have pointed out, recovery phases in the Australian economy have been accompanied by growing current account deficits. Indeed as Chart 9 shows both the trade and the current accounts have been exhibiting negative tendencies since the second half of 1991.

Given the differences between savings and investment in an economy, fluctuations in the balance of the current account must reflect the budgetary situation of the state sector. In the case of Australia during the 1987-88 fiscal year the move of the central government budget deficit into a surplus helped to restraint the growth of the current account deficit in 1987-88 and in 1989-90. During the same period investment expenditures were growing progressively larger than savings (Chart 12). However during the current phase of the cycle, the budget surplus has fallen significantly and the public sector as a whole has been in deficit since 1989-90. As indicated before this development reflects the effects of the recession on revenues and expenditures. As Chart 12 shows the deterioration in the fiscal situation may not necessarily worsen the current account since household savings have risen sharply since 1991 Q2. This rapid change is also confirmed by Chart 13 which shows household savings as a percentage of disposable income rather than of GDP. The continuing decline in the share of investment expenditures in the GDP (Chart 12) and the likelihood that the recovery in investment will not start until at least 1992 H.2, point to a healthier current account, or at least to no significant deterioration during the first half of this year.

The relative strength of the Australian dollar since 1990, maintained despite the declining interest rate differentials and depressed commodity prices, finally gave way after the most recent interest rate cut (Chart 14). A weaker Australian dollar may be a temporary phenomenon since the markets expect commodity prices to firm up during 1992. It must be noted, however, that the commonly accepted view of the Australian dollar as a commodity-driven currency has not been very helpful in explaining its relative strength and stability during 1990-91.

SUMMARY AND CONCLUSIONS

The signs of the start of the recovery phase of the Australian economy are still weak but are now more clearly defined. The recovery in consumer and investment expenditures will be aided by the recent cuts in interest rates but it is unlikely that these expenditures will show significant increases before 1992 H.1. Real interest rates are now falling in an environment of decreasing inflationary expectations. Trends in profitability, will be strengthened by surges in labour productivity particularly as these will be accompanied by moderate nominal wage increases. The stock market should reflect the twin positive influences of falling real and nominal bond yields as well as expectations of rising profitability.

TAIWAN
LIQUIDITY MANAGEMENT DURING THE NEXT EXPANSION.

During 1991 the Central Bank of China (CBC) has laid the groundwork for a sustainable economic recovery in Taiwan. Looking ahead to 1992 the CBC's major concern must be to avoid allowing an excessive build-up in liquidity. Such a build-up could translate into a runaway boom in domestic demand before an export recovery gains momentum. Such a development would lead to a deterioration in Taiwan's trade and current account surpluses, and would require a period of monetary restraint via higher interest rates and slower money growth if it were to be corrected in time for Taiwan to enjoy an orderly expansion on the back of recoveries in the USA, Japan and Europe.

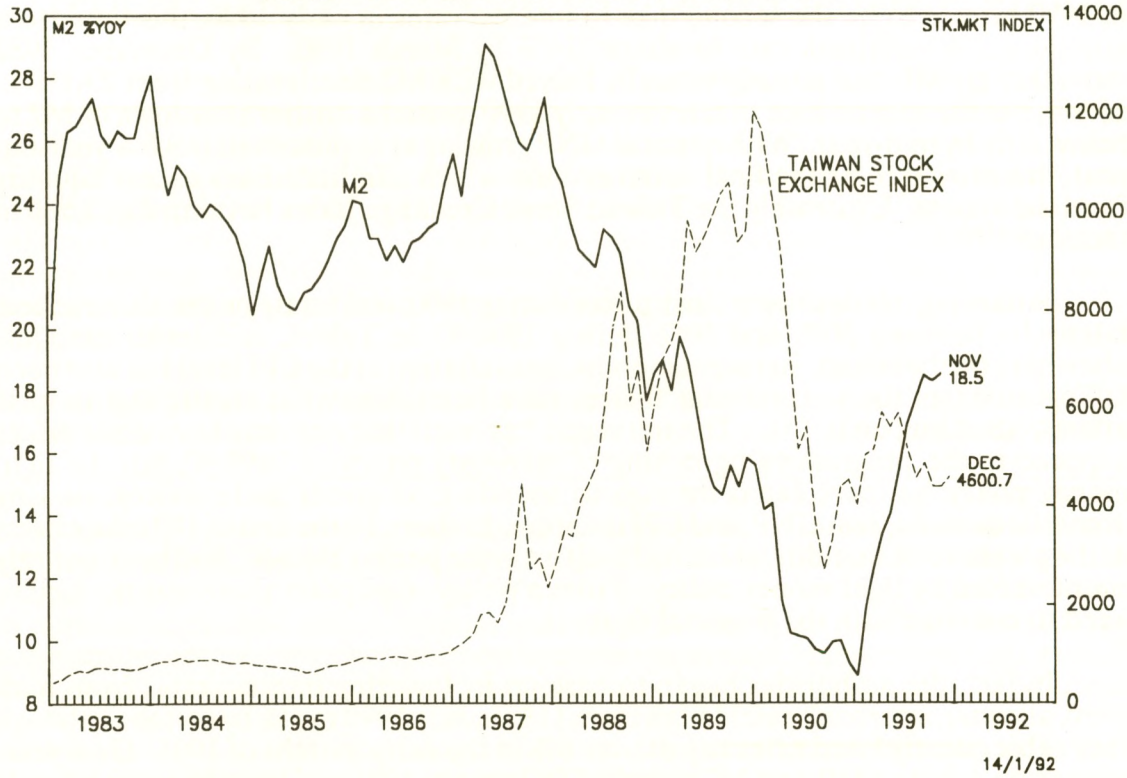
Among the most prominent factors making for liquidity management problems in the year ahead are (1) the continuing overall surplus in the balance of payments (currently reflected in the accumulation of foreign exchange reserves at the CBC to the massive sum of US$ 82 billion as at December 1991), and (2) the proposed issues of government bonds in connection with the government's 6-Year Development Plan. At first sight these would appear to have opposite consequences for liquidity -- the former adding to liquidity and the latter diminishing liquidity -- and indeed they might, but the recently discussed proposal to use the country's foreign exchange reserves to finance the Development Plan requires some examination as to its consequences for liquidity.

This article first summarises the main developments in monetary policy over the past three years, and explains how the Taiwanese authorities have succeeded in placing the economy in an ideal position for the launch of a new busines cycle upturn. Second, the shift to an easier monetary stance is explained and the consequences of a continued build-up of liquidity at present rates are explored. Third, the challenge of financing the 6-Year Development Plan in a non-inflationary manner is examined. An important conclusion is that if the country is to continue to run current account surpluses, then the Taiwanese authorities urgently need to allow the private sector to become responsible for the capital outflow instead of, in effect, nationalising the capital outflow via the central bank.

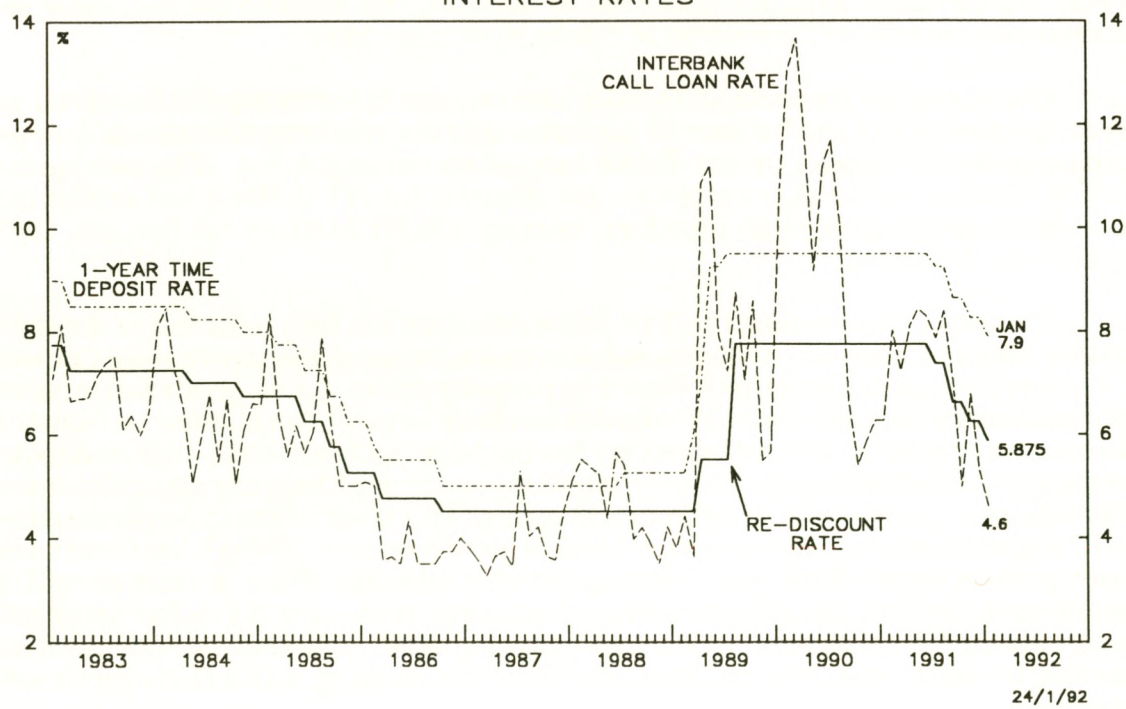
1. The Impact of the Tight Monetary Policy, 1989-90.

As shown in Chart 1, Taiwan's monetary growth as measured by M2 had grown at over 20% p.a. for the entire period 1983-87 until it peaked at 29.1% year-on-year in May 1987, though it continued to rise at over 20% p.a. until almost the end of 1988. Given ample monetary growth, the first two shocks to the equity market were essentially non-monetary. First there was the October 1987 "crash", when the Taiwan Stock Exchange Index almost halved, and then the second major shock to the equity market was the announcement of the Capital Gains Tax in September 1988. However, the Taiwan Stock Exchange Index did not peak until February, 1990. The reason was that, as Chart 2 shows interest rates rose only very modestly until April 1989 when the interbank call rate rose abruptly from around 4% to over 11%. This first monetary shock certainly caused the stockmarket to lose momentum, and the Taiwan Index consolidated for much of 1989 between 9,000 and 11,000 before making its final assault on 12,000 from January 1990. Subsequently, interest rates fell -- temporarily

TAIWAN: CHART 1
MONEY SUPPLY AND THE STOCKMARKET



TAIWAN: CHART 2
INTEREST RATES



-- from 11% to below 6% by yearend 1989. This enabled the stockmarket to rise to its all time high of 12,424 in February 1990. The critical factor causing the market to crash in 1990 proved to be the second hike in interest rates in early 1990, this time from around a 5% interbank rate to almost 14% by March 1990. By December 1989 monetary growth had already virtually halved with M2 decelerating from 29.1% to 15.9%, but the second hike in rates in early 1990 caused a further slowdown of M2 to below 10% by mid-year. With nominal GNP growing at approximately 9.6% year-on-year, this proved to be the final hammer-blow which eliminated any excess liquidity from the system. Ultimately the Taiwan Stock Exchange Index bottomed at 2,560 in October 1990.

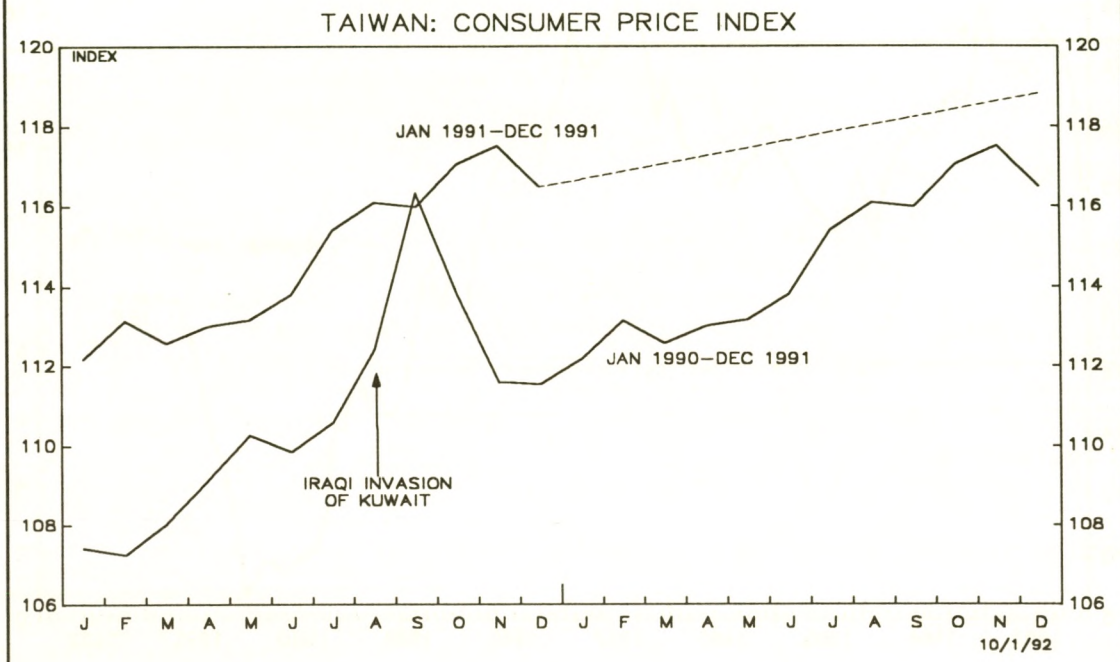
Following this decline in stock prices during 1990, real estate prices also cracked, falling by between 30% and 50% during 1990-91 in Taipei, and lesser amounts elsewhere on the island. In recent months, too, inflation at the CPI level has also been falling although the year-on-year figures have been somewhat erratic due to base effects. (See box on p. 15). The net result has been that not only have asset prices adjusted to the progressive tightening of monetary policy of 1989-90, but the tight money policy has percolated through to spending on goods and services, slowing domestic demand, real GNP, and CPI inflation. In short, by the end of 1991 the effects of the great excess liquidity which had built up in the period 1983-87, had been entirely counteracted by tight money policy. From a policy standpoint there was no further need to continue with the financial squeeze.

In fact, the authorities began to ease up by lowering interest rates from mid-1990, allowing interbank rates to fall from 11% in July 1990 to 5% by October, though they subsequently lifted rates to just over 8% in the early months of 1991. On a year-to-year basis both M1B and M2 troughed in January 1991 and have been on a firmly rising trend ever since. This has been assisted in the local money markets by a further reduction in Taiwan's short term call money rates from 8% to below 3% by yearend 1991. As the latest data in Chart 1 show, the CBC has allowed the monetary re-acceleration to take M2 growth to 18.5% by November 1991.

One reason for the precipitate fall in interest rates in recent months has of course been the strength of the balance of payments and the resulting net sales of foreign exchange for NT dollars on the Taipei foreign exchange market. The continuous selling pressure on foreign currencies (or demand for NT dollars) has driven the Taiwanese currency to an all time high, causing it to hit 24.65 on 8th January, 1992 against the US dollar.

To sum up this section, the Taiwanese economy has fully adjusted to the tight money policy of 1989-90. Asset prices fell in much the same way as one would expect -- equity prices came down first followed by property prices. Later, goods and services prices adjusted. By mid-1992 CPI inflation will have largely been eliminated from the Taiwanese economy. The real economy has not been badly affected. Indeed it looks as though Taiwan will escape from the monetary squeeze without any major deviation from its trend growth rate of 7-8% in real terms. This is significantly lower than the 9-12% growth rates of 1983-84, or the 11-12% growth rates of 1986-87, but these were both periods when there was a strong external stimulus (from a recovering US economy in 1983-84 and a depreciating US dollar in 1986 -- the NT dollar being still pegged to the US dollar until it started appreciating in 1987). In short, despite the hard landing for asset prices, the real economy looks like escaping with a fairly gentle soft landing.

Erratic Year-on-Year CPI Figures Reflect Bumpy Base ...
... Lower Inflation Ahead.

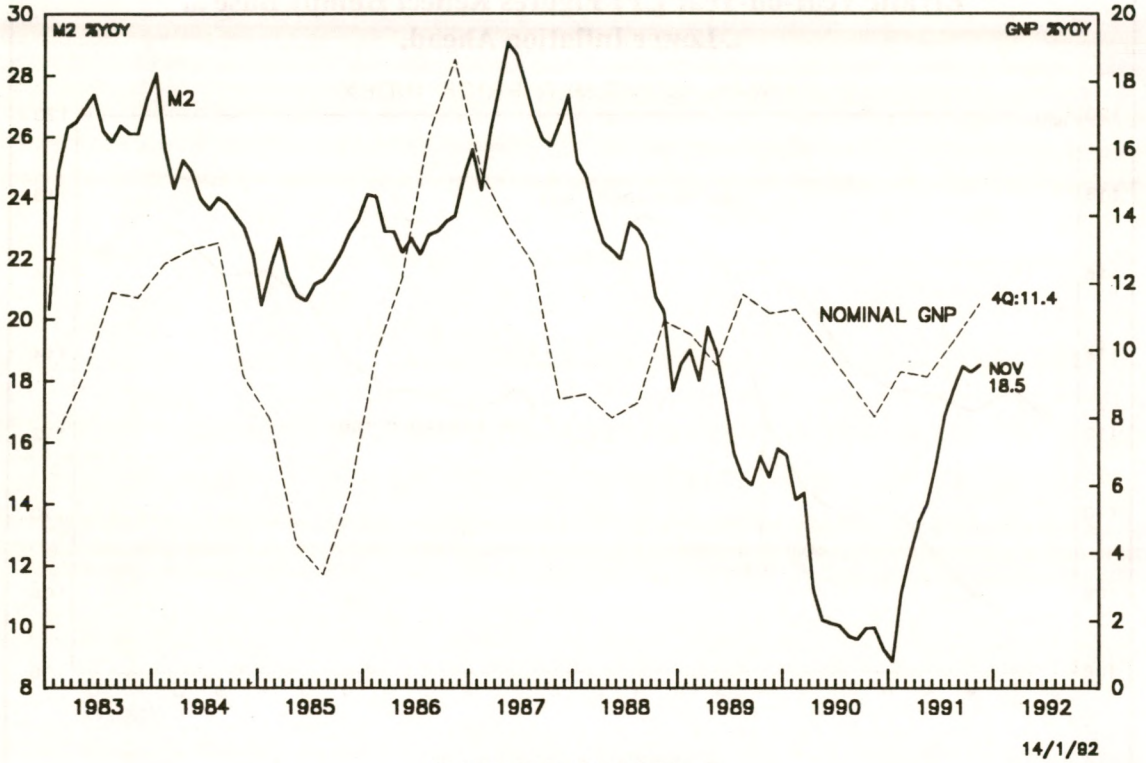


Year-on-year data for Taiwan's CPI have been unusually erratic over the past four or five months. The reason is not so much due to variations in the recent level of the index, but rather due to wide variations in the level of the index over the preceding year. In other words, base effects have overwhelmed recent month-to-month changes. As shown in the chart above, Taiwan's CPI rose very steeply in August and September 1990, immediately following the Iraqi invasion of Kuwait, and the consequent rise in the price of oil to over US$ 30 per barrel. However, that increase was soon counteracted -- in October and November of the same year -- resulting in a 3% absolute decline in the CPI betwen September and November 1990.

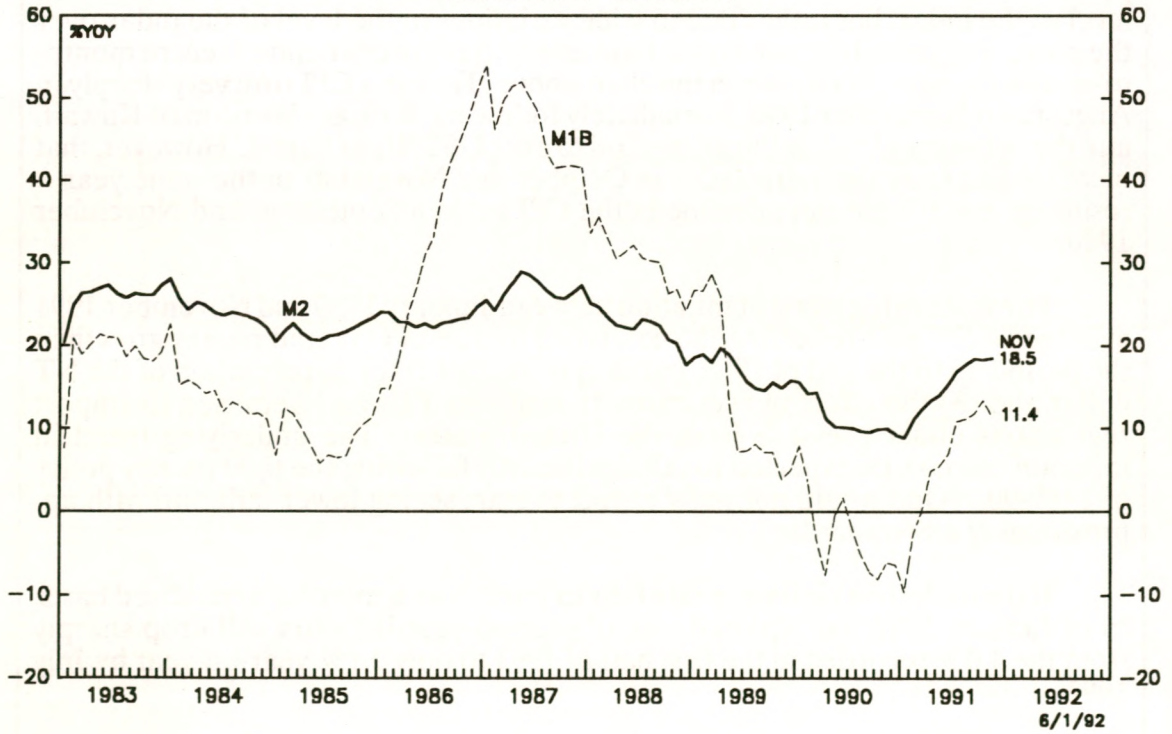
The underlying trend of inflation between January 1990 and November 1991 averaged 4-5% p.a., reflecting the combined impact of (1) rapid money growth in the period up to the end of 1988, partially offset by (2) the appreciation of the NT dollar and (3) the effect of reductions in tariffs as Taiwan liberalised its import regulations under pressure from the United States. The underlying trend in inflation can now be expected to fall significantly following the tight money policy of 1989-90. (One would normally expect to start seeing lower inflation with approximately a two year lag).

If the underlying inflation rate falls to just 2% on a monthly annualised basis, from January 1992 the reported rate of year-on-year inflation will drop sharply from the 4.0% recorded in the first half of 1991 to only 2.1% year-on-year by July 1992.

TAIWAN: CHART 3
MONEY SUPPLY AND GNP GROWTH



TAIWAN: CHART 4
MONETARY GROWTH



2. The Potential for an Excess Liquidity Boom.

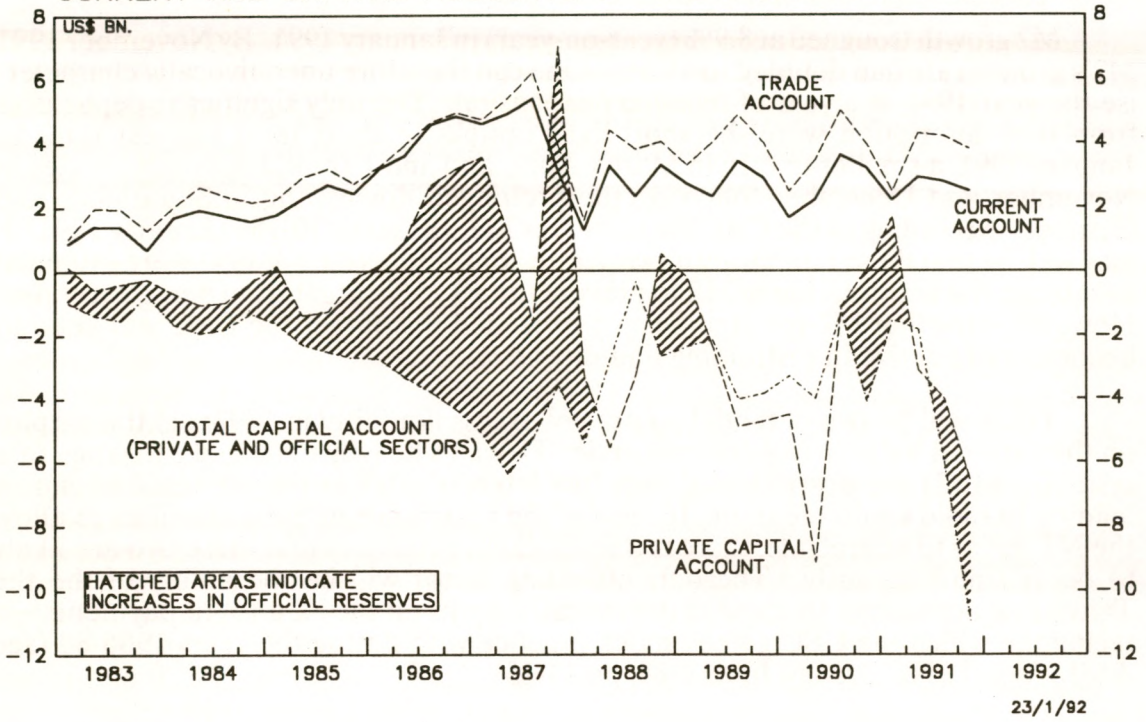
M2 growth troughed at 8.9% (year-on-year) in January 1991. By November 1991 M2's growth rate had doubled to 18.5%. One can therefore unequivocally characterise the year 1991 as a year of monetary expansion. The only significant departures from that description were the short-lived upticks in short term interest rates in January 1991, a smaller upturn in March-April, and another mild upswing of rates in November and December following the prolonged downswing in September and October. According to the CBC the target for M2 was set at 10-15% in early 1991. It may well be that these temporary upward rate adjustments during 1991 were intended to restrain the acceleration of M2 to prevent the 10-15% target from being exceeded. However, now that M2 has significantly exceeded this target the CBC will need to become more active in restraining liquidity growth.

There will be two potential sources of excess liquiditiy in 1992: (1) the surplus on the external balance of payments under Taiwan's heavily managed exchange rate system, and (2) the possibility of very low interest rates in the domestic economy leading to rapid credit creation. In view of the reluctance of the authorities to allow the NT dollar to appreciate, there is a significant probability that these two are likely to occur simultaneously. The only offsetting factor will be the ability of the the Taiwanese authorities to sterilise the overall surplus on the balance of payments -- a technique which the CBC gained much practice with during the years 1986-88 (see AMM Vol. 12 No. 3, May-June 1988, pp.14-25).

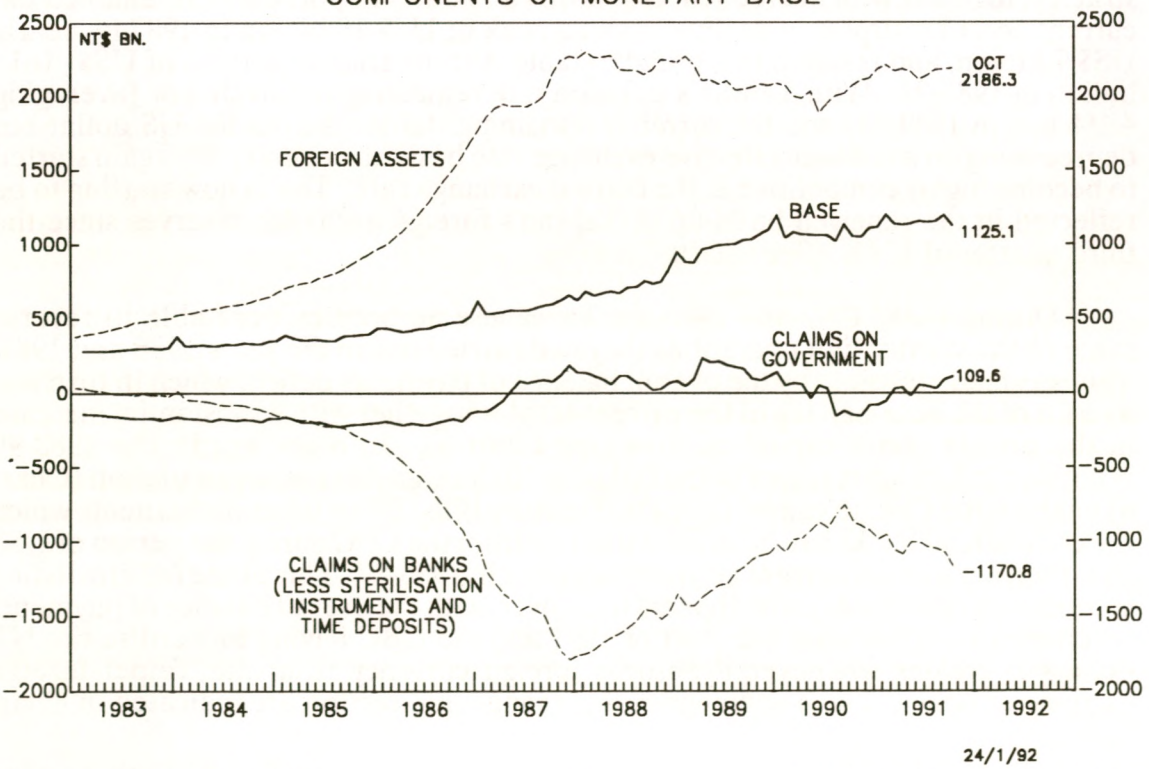
The structure of Taiwan's balance of payments is shown in Chart 5. Following the build-up of the current account surpluses in the years to 1987 the NT dollar appreciated by 58.8% against the US dollar between August 1985 to July 1989. This strategy, together with the reduction of tariffs and other import barriers, enabled the current account surplus to decline from its peak of US$ 18 billion in 1987 by nearly US$ 7 billion, and resulted in a broadly stable current account surplus of US$ 10-11 billion in 1988-91. With Taiwan's inflation rate remaining relatively low (averaging 4.1% p.a. in 1989-91) and the currency remaining stable vis-a-vis the US dollar but depreciating on a nominal effective exchange rate basis, the country has again started to become highly competitive at the current exchange rate. This is now starting to be reflected in the renewed build-up of Taiwan's foreign exchange reserves since the third quarter of 1991. (See Charts 5 and 6).

During 1988, 1989 and 1990 the Taiwanese authorities were able to reverse some of the sterilisation operations they had carried out in the years 1986 and 1987. This was made possible by the overall balance of payments deficit, which in turn was a result of the near-halving of the current surplus together with a substantial increase in the private sector capital outflow (see Chart 5). In other words, the 1988-90 reduction in foreign reserves or the reduction in foreign reserve accumulation (Chart 6) enabled the CBC to cancel the CDs, Treasury Bills "B", or other instruments which the commercial banks had been forced to buy from the CBC during the period of US$ 20 billion annualised current account surpluses in 1986-87. This phase (of unwinding sterilisation operations) now appears to be over, with the overall balance of payments reverting to surplus since the start of 1991 and the CBC having to sterilise the NT dollars it creates whenever it absorbs foreign currency from the Taipei foreign exchange market. The beginnings of this change in direction are indicated in Chart 7.

TAIWAN: CHART 5
CURRENT AND CAPITAL ACCOUNTS OF THE BALANCE OF PAYMENTS



TAIWAN: CHART 6
COMPONENTS OF MONETARY BASE



As and when the US economy recovers -- most probably in the second half of 1992 -- Taiwan's trade and current account surpluses can be expected to widen further. This will heighten the need for larger private sector outflows to offset the current account surplus, or -- if these are not forthcoming because private sector investors anticipate a higher return from holding their funds in NT dollars -- it will require the CBC to engage again in extensive sterilisation operations.

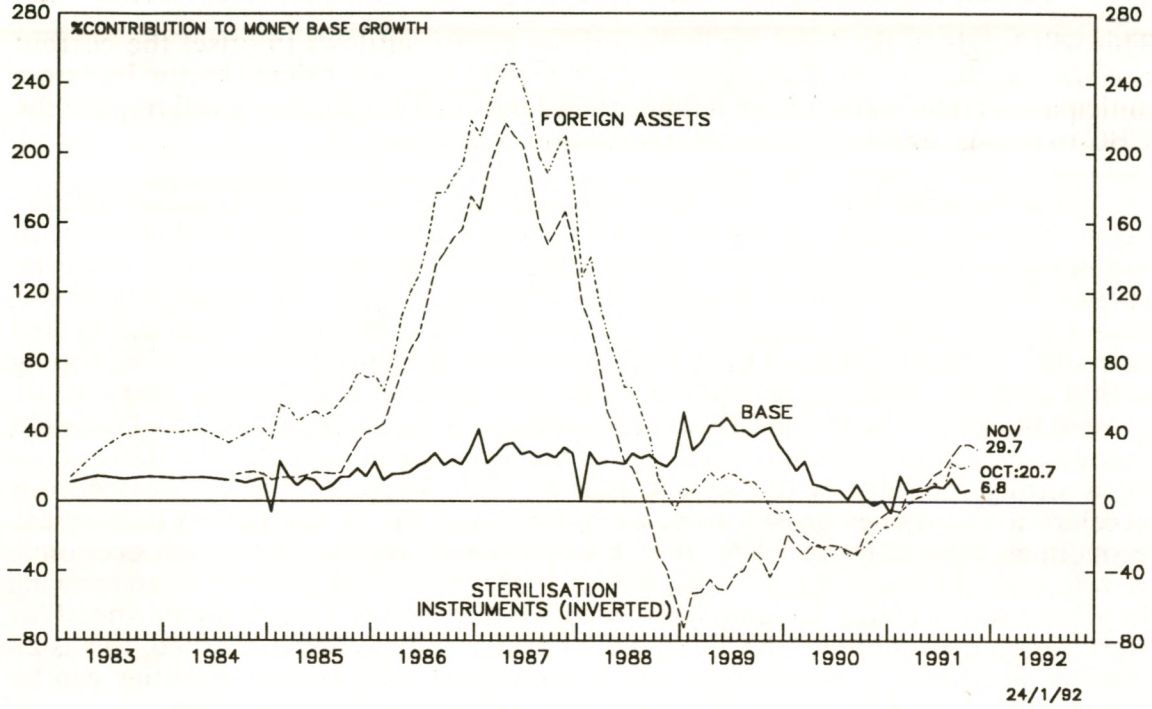
If at the same time there is some appreciation of the NT dollar and simultaneously a further reduction in Taiwanese interest rates, then it is highly likely that credit expansion will show much greater growth rates than are compatible with even the revised 18% monetary growth target of the authorities. This would require still further action by the CBC to neutralise the expansion of commercial bank assets and liabilities. In short Taiwan's CBC is likely to have its hands full during 1992 coping with a potential build-up of liquidity from both external and internal sources. At present the growth rate of the Taiwanese economy is subdued on account of the tight money policy in 1989-90 and on account of the recession in the USA, but there could be a strong recovery in the second half of 1992, triggered (a) by the vigorous acceleration in money growth since early 1991, and (b) by any upturn in overseas economies, especially the USA. It is this possible resurgence in the real economic growth rate of Taiwan in the second half of 1992 which could give rise to an upswing in private sector credit demand, which would in turn imply a much greater need for sterilisation operations by the CBC. So far as asset prices are concerned, this is an ideal combination of circumstances to fuel an asset price boom. Equities can be expected to move first, followed at some later stage by real estate prices.

3. <u>The Financing of the 6-Year Development Plan, 1991-96.</u>

Another reason to be concerned about the possibility of an excess liquidity boom is that the authorities now have the additional responsibility of financing the very large and ambitious 6-Year Development Plan -- some of it with bonds -- and there will inevitably be a temptation for the authorities to allow interest rates to fall to excessively low levels in order to ensure that the bonds are successfully placed.

The mammoth 6-Year Development Plan, involving 775 projects, is budgeted at NT$ 8.2 trillion. This is slightly under twice the 1990 nominal GNP of NT$ 4.3 trillion, and is estimated to be equal to 21.4% of nominal GNP over the period of the Plan, 1991-96. (See Table 1). Currently government consumption expenditure amounts to about 17% of the GNP. Government expenditure on fixed capital formation is not separately identified in Taiwan's national income statistics, but the Plan documents indicate an intended growth rate of 15.5% for fixed investment by government during the period of the Plan. "In the first three years of the plan period, public sector investment will expand more rapidly than that of the private sector. This expansion of public investment is expected to boost private investor sentiment and stimulate growth in private investment. Beginning in the fourth year of the plan, real investment growth in the private sector will exceed that of the public sector, with the private sector providing the major contribution to growth in domestic fixed investment."

TAIWAN: CHART 7
CONTRIBUTIONS TO CHANGES IN THE MONETARY BASE



TAIWAN: CHART 8
SAVINGS AND INVESTMENT AS A % OF GDP

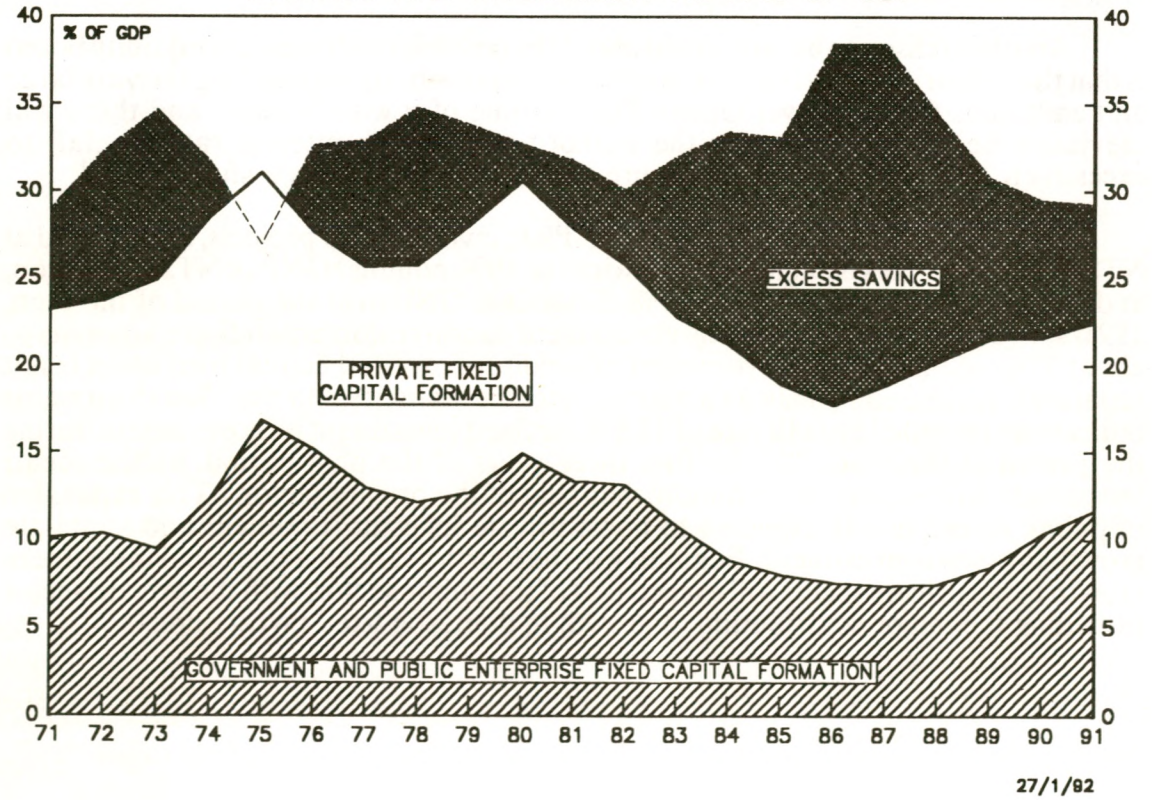


TABLE 1.

PROVISIONAL COMPOSITION AND FUNDING OF 6-YEAR DEVELOPMENT PLAN.

	NT$ trillion	% of Projected 1991-96 GNP
Composition		
Total Plan Spending	8.2	21.4%
Govt. Current Expenditures	1.9	4.9%
Govt. and Public Sector Capital Projects	5.2	13.6%
Private Sector Investments	0.6	1.6%
Other	0.5	1.3%
Funding		
From Regular Tax Revenues	2.5	6.5%
From Fiscal Surpluses	2.5	6.5%
From Govt. Enterprises	2.1	5.5%
From Bonds, Privatisations and other sources	1.1	2.9%

The Plan contains four main sections: (1) MacroEconomic Development Targets; (2) Providing Sufficient Resources for Continued Industrialised Growth; (3) Promoting Balanced Regional Development, and (4) Raising the Quality of National Life. As many of the subcomponents are quite platitudinous only a bare outline will be given here.

(1) The macro-economic development targets assume an average annual growth of the real GNP of 7.0% p.a., accompanied by inflation of 5.0% in 1991 and 3.5% in the subsequent years of the Plan. Agriculture will maintain zero growth, while for industry there is extensive emphasis on strengthening R&D, promoting automated production, upgrading product quality and preventing pollution. The planners expect industrial production to grow marginally more slowly than the GNP (6.9% p.a.), with heavy or capital intensive industries increasing their share and light or labour intensive industries reducing their share. Consistent with the expereince of other fast-growing Asian economies, the planners expect the service sector to grow faster than the overall economy at 7.8% p.a.

(2) Industrial growth is deemed to require substantial public sector investments as outlined in Table 1. These are divided into some eight categories including, for example, the creation of new high technology industrial parks; the conversion of "unproductive" farmland to intensive industrial, commercial, residential or recreational use; a variety of schemes to store water and control its distribution for irrigation or for domestic and industrial supply; manpower training schemes to increase labour

productivity; enhancing energy supplies (Taiwan has suffered a series of brown-outs or even power cuts in recent months); development of the island's transportation systems; extension of telecommunications systems, and the improvement of scientific or technological research.

(3) and (4). The sections of the Plan devoted to balanced regional development and raising the quality of national life call for a slowdown of the flow of population to the congested urban centres by developing 18 self-contained "living perimeters" with facilities to meet the six major social needs of residents; working, housing, recreation, schooling, medical services and shopping. There is a good deal of rhetoric about achieving more equitable apportionment of services among the regions, as well as narrowing the gap in living standards between regions. Finally there is a series of projects designed to improve the environment through garbage disposal, industrial waste disposal, the building of sewer systems, and measures to alleviate air and water pollution.

TABLE 2.

ESTIMATE OF TOTAL CAPITAL REQUIRED FOR MAJOR PUBLIC DEVELOPMENT PROJECTS UNDER THE 6-YEAR NATIONAL DEVELOPMENT PLAN, 1991-96.

	Category	Number of Projects	Estimate of Funds Required	Percent of Total Budget
1.	Agriculture, Forestry and Fisheries	79	267.23	3.3
2.	Irrigation, Water Conservation and Flood Control	61	444.38	5.4
3.	Transportation and Communications	100	2,771.37	33.7
4.	Urban Development and Housing	44	931.22	11.3
5.	Tourism and Recreation	30	126.53	1.6
6.	Culture and Education	93	790.69	9.5
7.	Science and Technology	67	233.46	2.8
8.	Energy Development	77	999.83	12.1
9.	Industrial Sector Manufacturing	73	334.14	4.1
10.	Industrial Service Sector	10	40.77	0.5
11.	Environmental Protection	67	289.65	3.5
12.	Public Health	9	107.76	1.3
13.	Social Welfare and Security	39	794.76	9.6
14.	Other	26	106.44	1.3
	TOTAL	775	8,238.23	100.0

Note: "Projects and preliminary cost estimates for the period of 1991-96 are prepared by sponsoring agencies. Some of the projects have been approved by the government; some are still on the drawing board. All are subject to change due to budgetary constraints."

Given the excess of savings over investment in Taiwan in recent years (Chart 8) amounting to between 5% and 20% of GNP there would appear to be ample scope for Taiwan to change its growth pattern towards more emphasis on domestic demand, less emphasis on production for exports, and -- arguably -- a greater role for public sector activity in the Taiwanese economy. (An alternative approach would be through the lifting of domestic regulations and imports restrictions to permit the private sector to invest more in consumption and leisure industries. This would be a preferable, market-oriented solution). The financing of the 6-Year Plan, as indicated in Table 1, implies drawing down on fiscal surpluses and depending substantially on funding by public sector enterprises. The authorities have also embarked on a sizeable bond-issue programme to supplement existing government revenues. Insofar as these plans are <u>not</u> financed by the monetisation of debt issues, there would appear to be no serious obstacle to placing these bonds, though it will be desirable to permit the domestic financial markets to develop more freely so that investors have a wide range of maturities and denominations to choose from.

It has also been suggested, perhaps more by the foreign press than domestic commentators, that Taiwan should use its huge foreign exchange reserves to help finance the 6-Year Development Plan. How can this be achieved? Is it feasible?

In broad terms the Taiwanese have build up a huge volume of foreign exchange reserves over the past six years which represents potential claims on foreign countries. To exercise those claims without disruption to the domestic economy, macro-economic policy should be managed so as to produce a steady overall balance of payments deficit (corresponding to or symmetrical with the surpluses which caused the original accumulation of foreign exchange reserves), lasting ideally until 1996 and perhaps with the objective of reducing the foreign exchange reserves to about US$ 30 billion. The simplest way to do this would be to allow the currency to appreciate to a point where it is slightly overvalued, thus encouraging an excess of imports over exports and/or encouraging private sector investment abroad. The run-down in foreign exchange reserves could be matched, in a monetary sense, by CBC purchases of domestic assets (e.g. government bonds, T-Bills, commercial paper etc.) thus avoiding any undesirable deceleration in monetary growth. In terms of resources, the run-down of foreign exchange reserves (i.e. the loss of foreign assets by the central bank), could be matched by purchases of goods and services from overseas either by the Taiwanese government -- perhaps as part of the provision of capital equipment specified in the Plan -- or by the Taiwanese private sector. However, the actual implementation of such a scheme would require very skillful management.

Two cases can be considered: first the case where the country's foreign exchange reserves remain in the hands of the monetary authority (CBC), and second the case where some of the reserves can be transferred to the fiscal accounts of the government.

In the first case we presume the foreign exchange cannot be spent on foreign goods or services (because the CBC is not one of the agencies of the government charged with implementing the plan), so the only alternative is to convert the foreign currency to domestic currency with the idea that the proceeds be used in Taiwan. Assuming the CBC intends to maintain steady money growth or a steady growth rate of the monetary base, this conversion can only occur (a) if Taiwan's overall balance of payments is in deficit, or (b) if the CBC is prepared to offset a reduction in foreign

reserves by an increase in domestic assets. In (a) the sale of foreign currency on the Taipei foreign exchange market by the CBC will be matched by an acquisition of foreign assets by the Taiwanese private sector, with the result that the CBC's foreign assets will have declined, and the government will have gained no additional resources. In (b) the CBC sells foreign currency (pushing up the NT dollar), but then offsets the effect of the corresponding decline in the base by buying domestic assets (T-Bills, commercial paper etc., or it may make direct loans to the commercial banks). If it purchases T-Bills or other government debt with the proceeds of the foreign exchanges sales, then it will in effect be creating resources for the government to use in financing the 6-Year Plan. In theory the CBC could continue reducing reserves and creating a monetised domestic asset to replace the lost reserves until all its foreign reserves are used up. However, unless there is an overall balance of payments deficit, this would cause the NT dollar to rise very strongly on the foreign exchange market, which would ultimately have severely depressing effects on exports and related economic activity.

Under the second case it is assumed that it is legally permitted for foreign exchange resrves to be transferred to the fiscal accounts of the government. In this case the government will have acquired a foreign asset which it can either use to pay for imports required in the Plan, or it can convert the foreign currency to NT dollars and use them to pay for goods and services on the domestic market. Again, this will either require the private sector to be running an overall balance of payments deficit if it is not to result in a sharp appreciation of the NT dollar, or it will require offsetting actions by the CBC to neutralise the sales of foreign exchange (= purchases of NT dollars) by the government. In short, it is evident that under both scenarios the CBC will need to become more vigilant in ensuring that monetary stability is maintained in the course of such transactions. In view of the susbstantial size of the funding required from non-tax sources or from the private sector (up to NT$ 1.1 trillion or about US$ 42 billion), the size of the implied foreign exchange transactions is so large as to warrant special watchfulness on this issue. To conclude, supplementary financing via the use of foreign exchange reserves is feasible, but the CBC will need to be particularly vigilant if it is to avoid serious consequences for domestic monetary growth or for the value of the currency and hence the prospects for the export sector.

CONCLUSION AND FORECAST: In 1989-90 the Taiwanese monetary authorities implemented a tight monetary policy which was relaxed sufficiently in 1991 to prevent the economy suffering a hard landing. Although asset prices tumbled, the overall economic growth rate slowed to a highly respectable 5% in 1990, and has been recovering to an estimated 7% in 1991. The main danger facing the authorities in 1992 is a repetition of the excess liquidity boom of 1986-87 as the trade and current account surpluses build up again, and as the currency again comes under upward pressure on the Taipei foreign exchange market. The easiest way out of this dilemma would probably be to allow the currency to appreciate to a point where the private sector was running an overall balance of payments deficit (i.e. current and capital accounts combined), and offset this with a planned rundown of foreign exchange reserves which in turn would be offset (in a monetary sense) by the central bank purchasing government debt to help finance the giant 6-Year Development Plan. Such a scheme is unfortunately unlikely to be implemented given the fundamentally mercantilist bias of the authorities. Instead, it seems much more likely that the authorities will engineer

a repeat of the last episode, i.e. a build-up of the current account surplus, a corresponding excess of savings over investment in the private sector, combined with a steady but reluctant upward revaluation of the currency which will further discourage private sector capital outflows. To prevent excessive monetary growth the CBC will once again engage in extensive and complex sterilisation operations, essentially taking the excess savings from the private sector and holding them at the central bank. The counterpart to these transactions will be another surge in Taiwan's foreign exchange reserves.

A far better solution would be to allow (and encourage) Taiwan's private sector to invest abroad, thus offsetting any current account surplus with capital outflows from the private sector, and thereby avoiding the somewhat pointless further accumulation of foreign exchange reserves in the hands of the CBC. In the short term this might require the currency to be maintained at a slightly overvalued level, but in the longer run this would lead to a much better allocation of resources and enable the country as a whole to earn better returns than the CBC is able to earn from its holdings of cash, T-Bills and bonds in foreign currencies (particularly if the NT dollar ends up being revalued by 40% or more as it was in 1987-89). Having achieved a highly successful unwinding of the boom of the late 1980s it would be a pity to see the CBC repeat the whole experience so soon again in the 1990s.

THAILAND
CYCLICAL ADJUSTMENT IS NOT YET COMPLETE

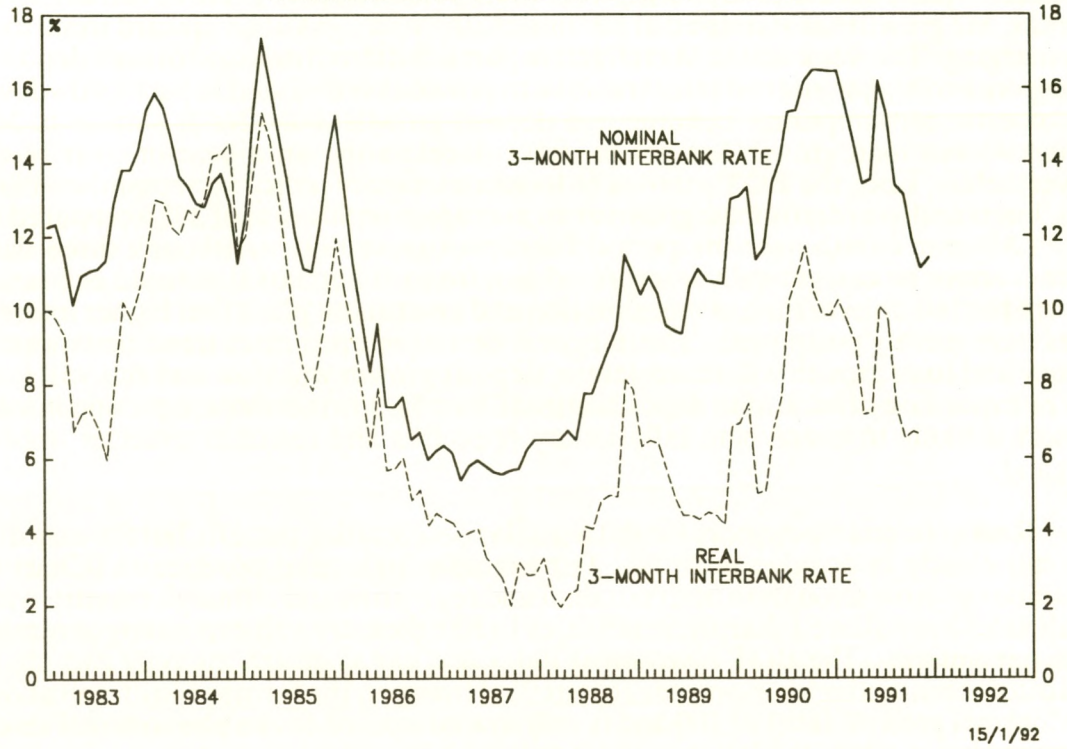
The growth of the Thai economy is estimated to have slowed to 7.9% during 1991 following three years of stellar, double-digit GDP expansion. However, the Thai authorities seem confident that they can ride through the current global slowdown with barely a hiccup in growth and are forecasting an acceleration in GDP to 8.1% during 1992. This article argues that although the GDP target may well be met as a result of recent easings in monetary policy and fiscal stimulus, such growth will be at the expense of little improvement in either inflation or the current account deficit. Such a scenario implies that monetary policy will need to be tightened once again towards the end of 1992, impacting on economic growth in 1993. The alternative (and less likely) scenario envisages a far quicker pre-emptive reversal in monetary policy -- possibly after the planned March-April 1992 elections -- which would undermine the 1992 growth forecasts. Either way, GDP acceleration, lower inflation and a narrower current account deficit during 1992, do not appear to be consistent goals.

From the beginning of 1990 until the middle of 1991, the Bank of Thailand (BOT) was running its tightest monetary policy -- in terms of both the level of nominal and real interest rates -- since 1985 (Charts 1 and 2). Interbank rates had been trending upwards from their 1987 cyclical low due to strong demand for credit in the economy, and spiked up further when the BOT began to tighten actively at the beginning of 1990. The first round of tightening in March and April 1990 -- the BOT discount rate and the lending rate ceiling for commercial banks were both raised 150 basis points to 9.5% and 16.5% respectively -- coincided with the decontrol of interest rates on almost all bank deposits. Competition for funds caused deposit rates to climb steeply which in turn pushed prime rates up towards their ceilings. However, demand for credit remained strong and in November 1990 the BOT raised both the discount rate and the lending rate ceiling a further 250 basis points.

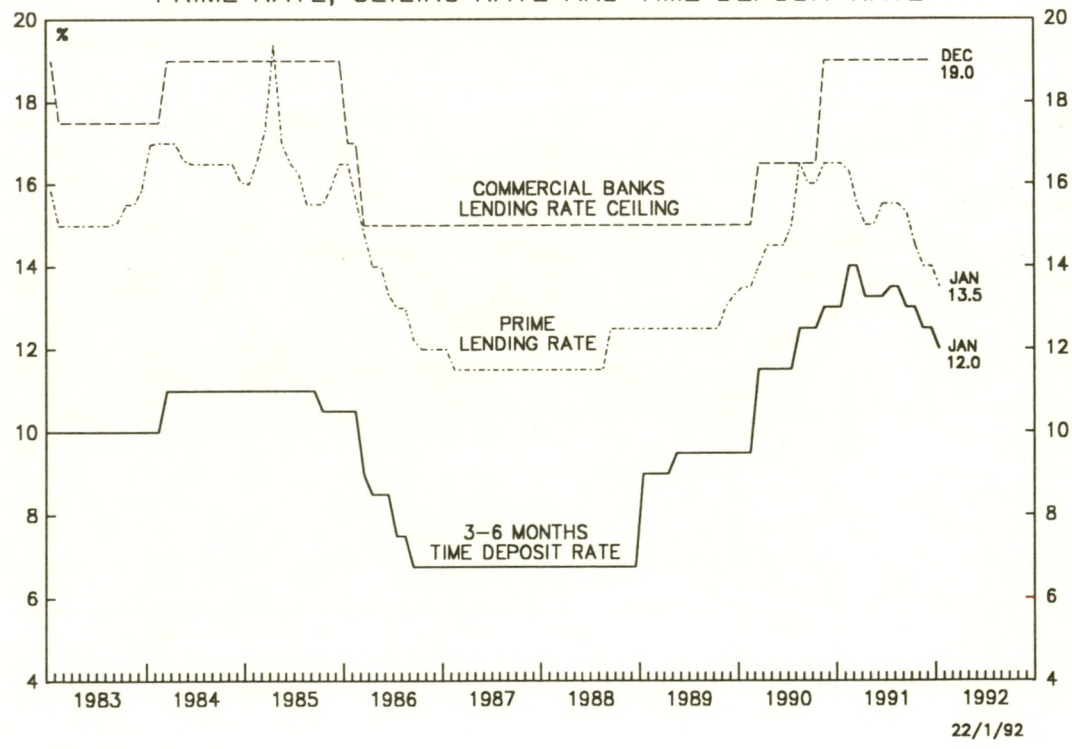
Monetary policy tends to be a blunt instrument operating through the economy with a lag effect. This is especially true in an economy like Thailand which has a virtually open capital account of the balance of payments and an effectively pegged currency. Nevertheless, the BOT believes that the short, sharp monetary shock administered has been sufficient to engineer a "soft lending" for the overheated economy and has accordingly started to lower interest rates. Interbank and lending rates have been trending down since the beginning of 1991. Initially, this was due mainly to a Gulf war-induced loss of confidence resulting in a reduction in loan demand, and interest rates rose again at the conclusion of hostilities. However, in recent months, the BOT has intervened actively to push down rates further by lowering its discount rate 1% to 11% in September 1991, and by injecting funds into the interbank market.

At this juncture it is unclear whether the BOT's relaxation is timely or premature. Certainly a range of indicators -- both monetary and real economy -- show a relative slowdown over the second half of 1991, but absolute levels/growth rates remain high and in some cases are exhibiting signs of resurgence.

THAILAND: CHART 1
NOMINAL AND REAL INTEREST RATES



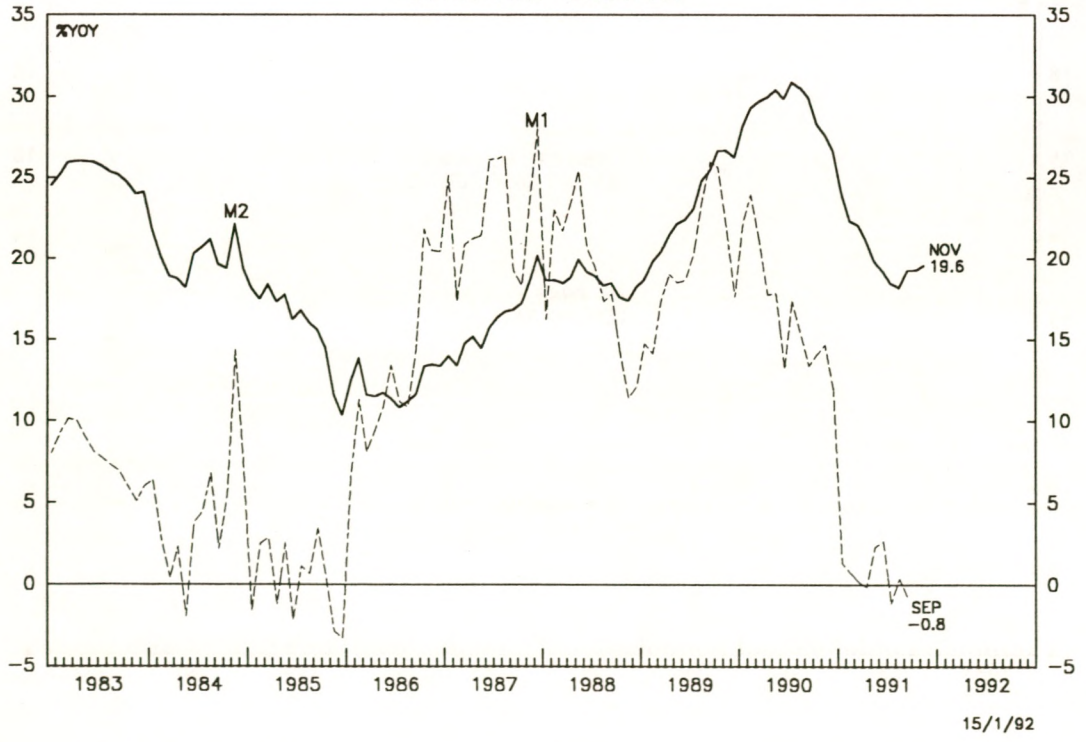
THAILAND: CHART 2
PRIME RATE, CEILING RATE AND TIME DEPOSIT RATE



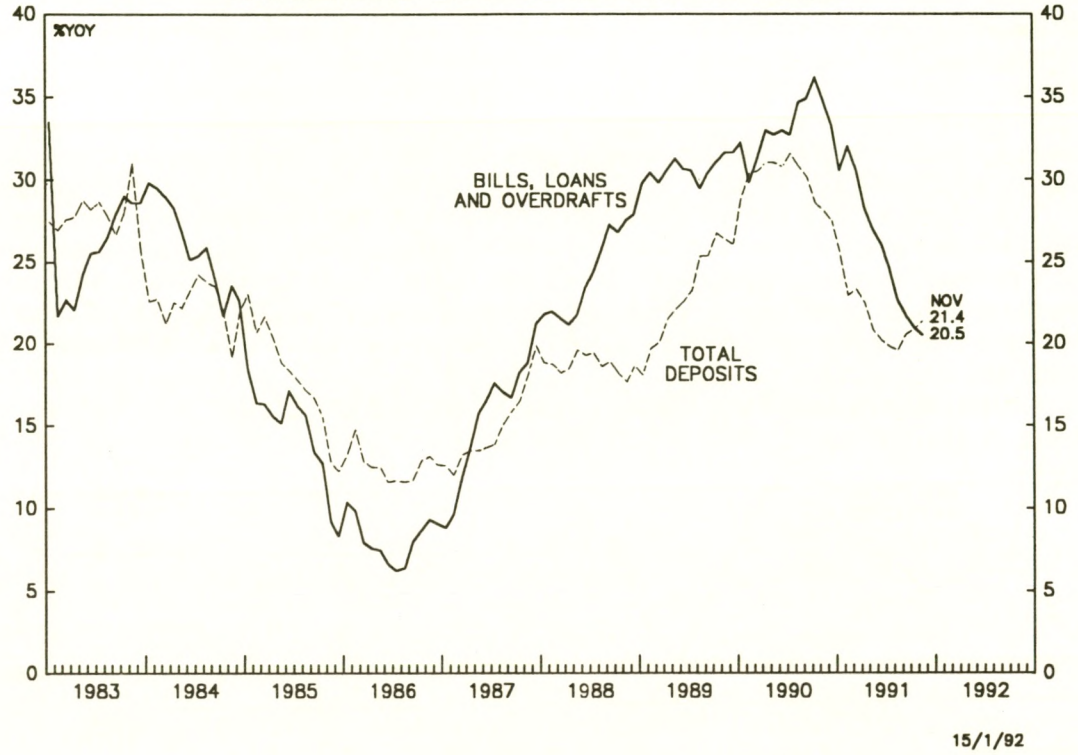
Turning to the monetary sector first, both broad and narrow money -- especially the latter -- have decelerated sharply from their peaks (Chart 3). However, in recent months, M2 growth has stabilised at just under 20% and signs of an upward trend may be emerging. The weakness in M1 reflects in part a shift from demand to time deposits in response to higher interest rates (relative to previous years), and in part a slowdown in domestic consumption. Lending and deposit growth show trends similar to M2 (Chart 4) but loan growth has yet to cease decelerating on a year-on-year basis. Nevertheless, since the BOT's moves to loosen monetary policy in September 1991, bills, loans and overdrafts have grown at an average monthly rate of 2%, compared to only 1.3% per month over the period January-August 1991. Although three data points cannot be categorically interpreted as a trend, it appears that rapid economic growth has left an overhang of consumption and investment plans that higher interest rates have merely postponed. The danger is that as interest rates trend downwards, money and loan growth will reaccelerate, deposit growth will slow and this will lead to a re-expansion of bank loan deposit ratios (Chart 5). Furthermore, a pick up in loan growth is likely to exacerbate inflationary pressures and result in stronger import demand.

Real economic indicators exhibit a similar decelerating pattern, but the majority are still clearly in positive territory. For example, industrial production (Chart 6) continues to grow strongly in both nominal and real terms and although country-wide retail sales have slowed sharply, retail sales in Bangkok are still expanding at almost 10% per annum. The BOT investment index and car sales are the only two major indicators contracting year-on-year (Chart 7). However, the former is still well above the "normal growth" level of 100 and is only low compared to the phenomenal levels of recent years, while the latter appears to have bottomed out.

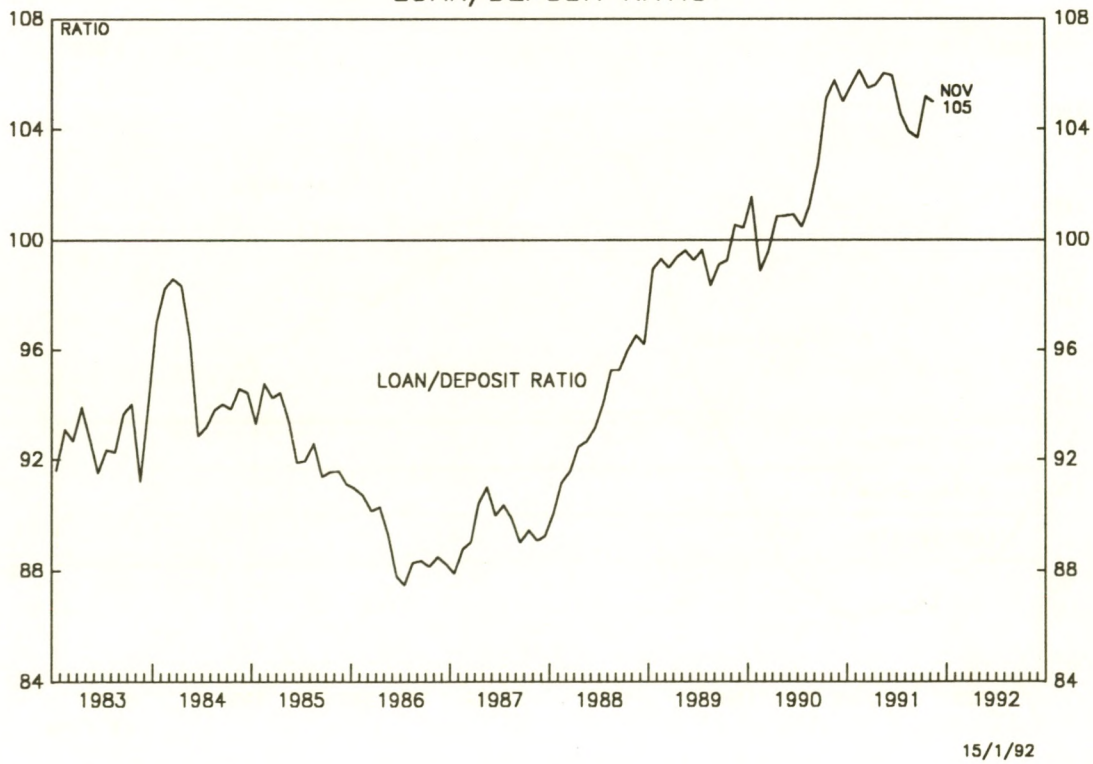
THAILAND: CHART 3
MONETARY GROWTH



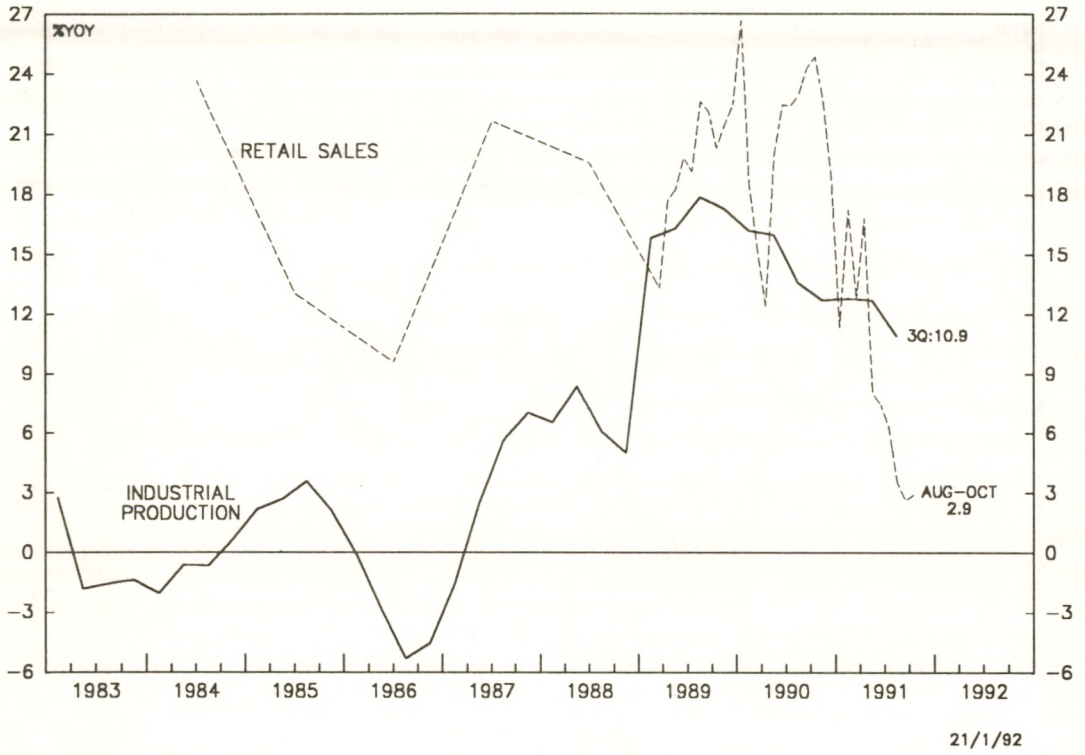
THAILAND: CHART 4
COMMERCIAL BANK LOANS AND DEPOSITS



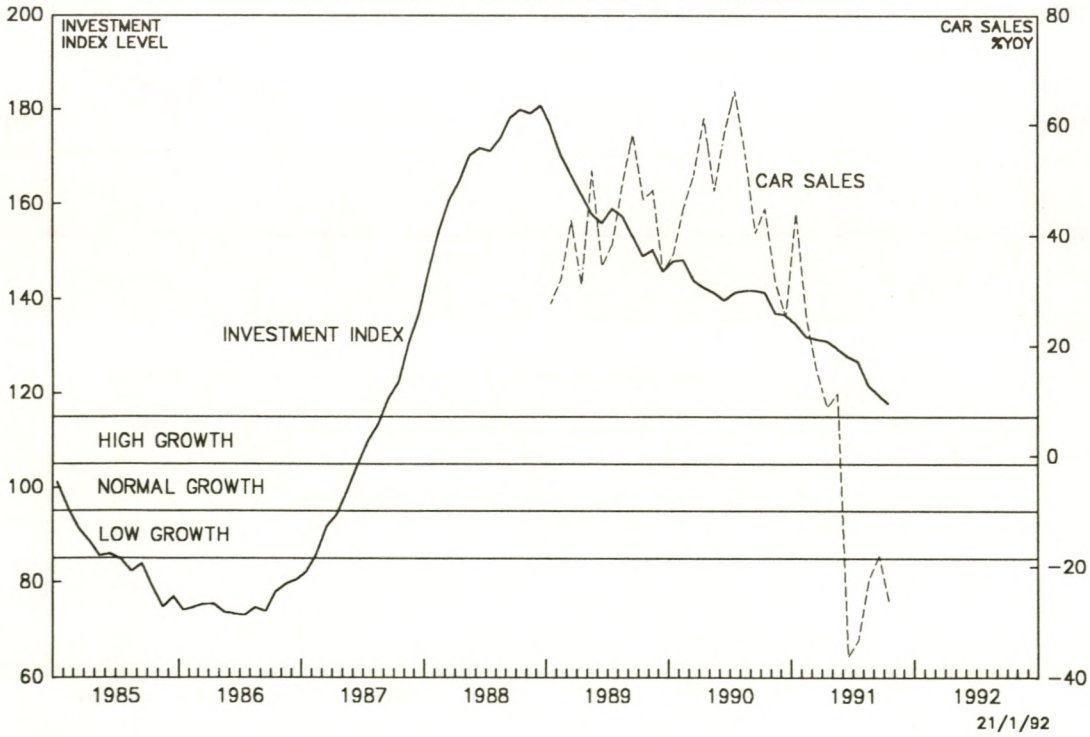
THAILAND: CHART 5
LOAN/DEPOSIT RATIO



THAILAND: CHART 6
INDUSTRIAL PRODUCTION AND RETAIL SALES



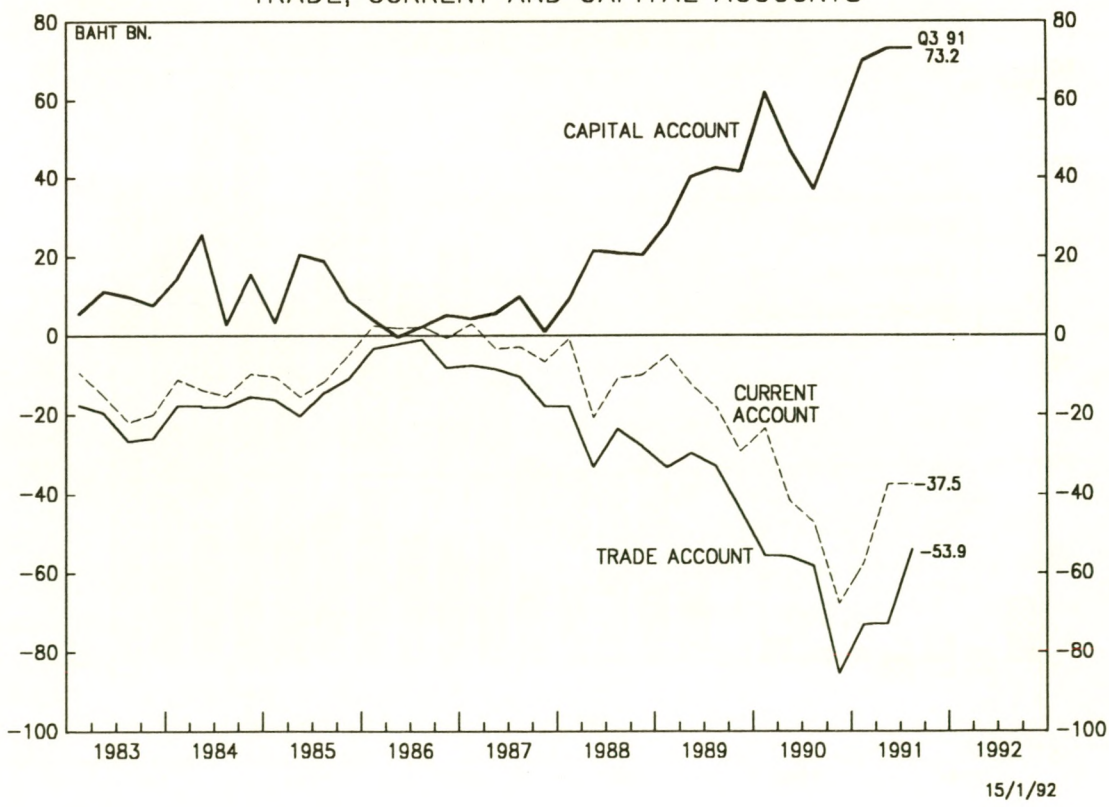
THAILAND: CHART 7
INVESTMENT INDEX AND CAR SALES



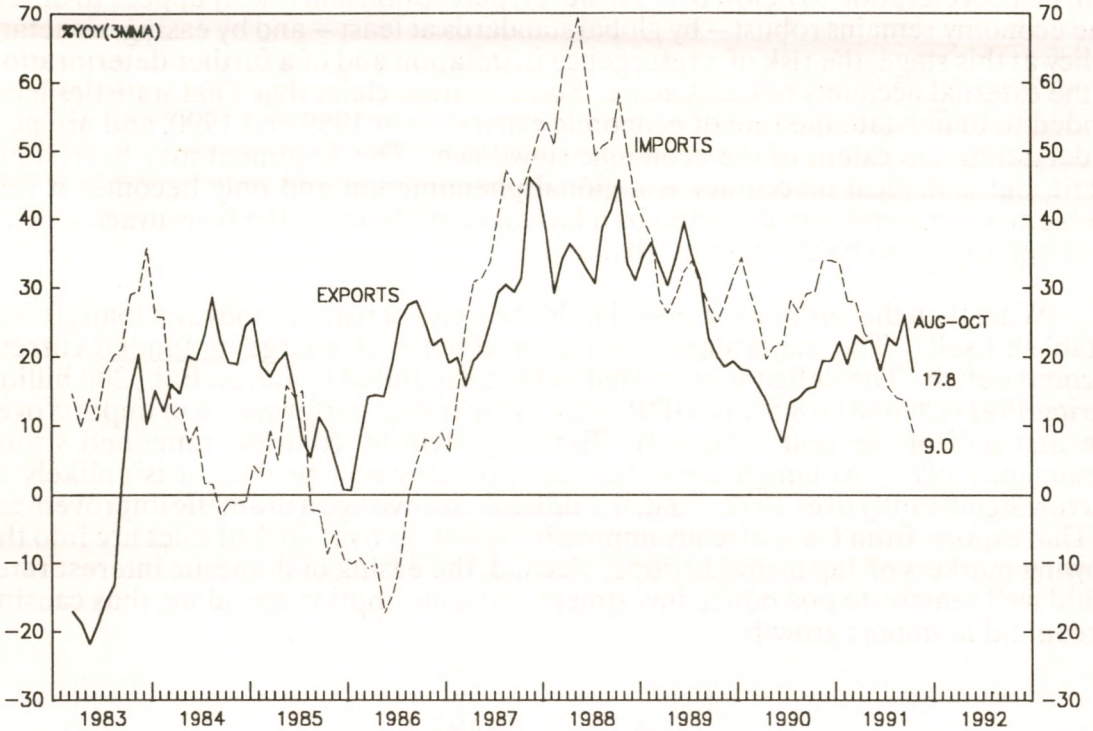
It is only natural that after three years of double-digit growth, Thais have felt the pain of a deceleration to below 8%. However, perception and reality appear to differ. The economy remains robust -- by global standards at least -- and by easing monetary policy at this stage, the risk of a resurgence in inflation and of a further deterioration in the external accounts remains acute. Some sources claim that Thai statistics have tended to understate the rate of economic expansion in 1989 and 1990, and are now understating the extent of the economic slowdown. This argument may have some merit, but statistical inaccuracy is a global phenomenon and only becomes a real problem when trends are distorted by a lack of consistency in the inaccuracies. This does not appear to be the case in Thailand.

What then the outlook for 1992 should the trend of rising money and loan growth establish itself? The major danger is the emergence of a large, unfunded current account deficit. The deficit is estimated to have expanded to almost Baht 200 billion during 1991 (Chart 8) -- 8.5% of GDP -- due to the robust performance of imports over the first half of the year (Chart 9). Export growth by contrast, remained strong throughout 1991. Although the deficit has probably now peaked, it is unlikely to narrow significantly over 1992. First, it is difficult to envisage a dramatic improvement in Thai exports from these already impressive levels, as over 40% of sales are into the slowing markets of Japan and Europe. Second, the easing of domestic interest rates could well reactivate postponed investment and consumption spending, thus causing a rebound in import growth.

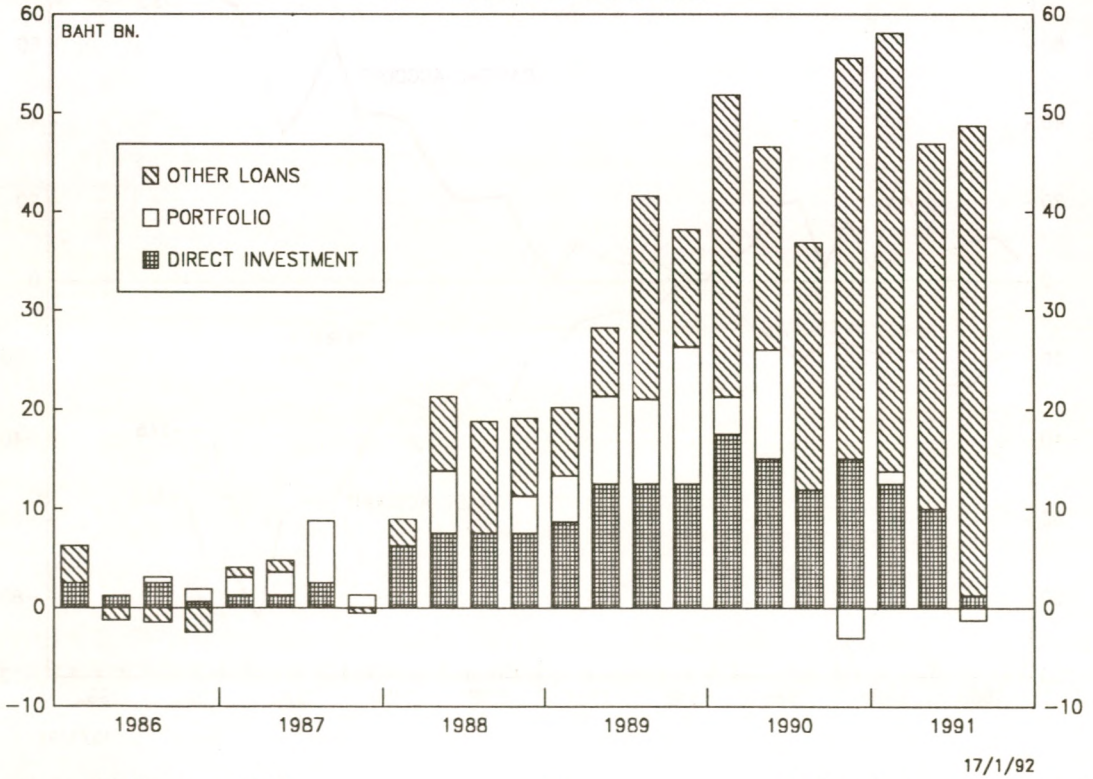
THAILAND: CHART 8
TRADE, CURRENT AND CAPITAL ACCOUNTS



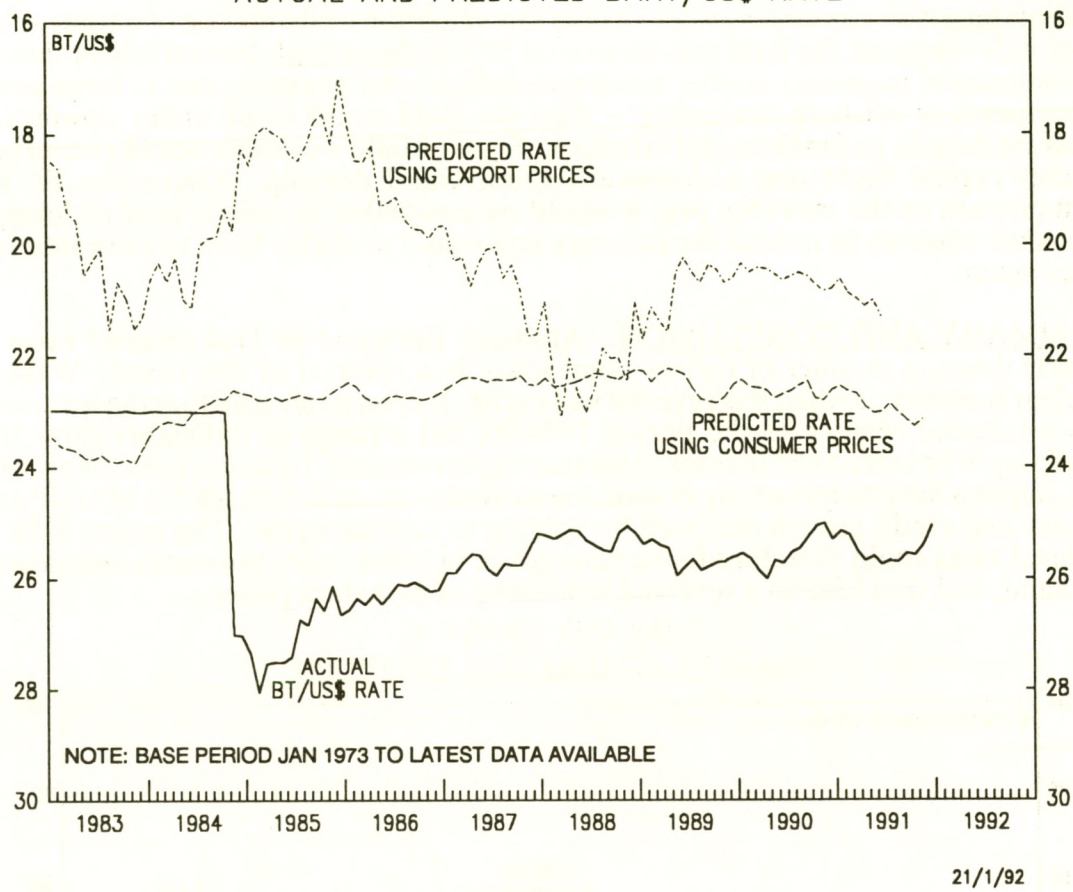
THAILAND: CHART 9
EXPORTS AND IMPORTS GROWTH



THAILAND: CHART 10
NET CAPITAL INFLOWS



THAILAND: CHART 11
ACTUAL AND PREDICTED BAHT/US$ RATE

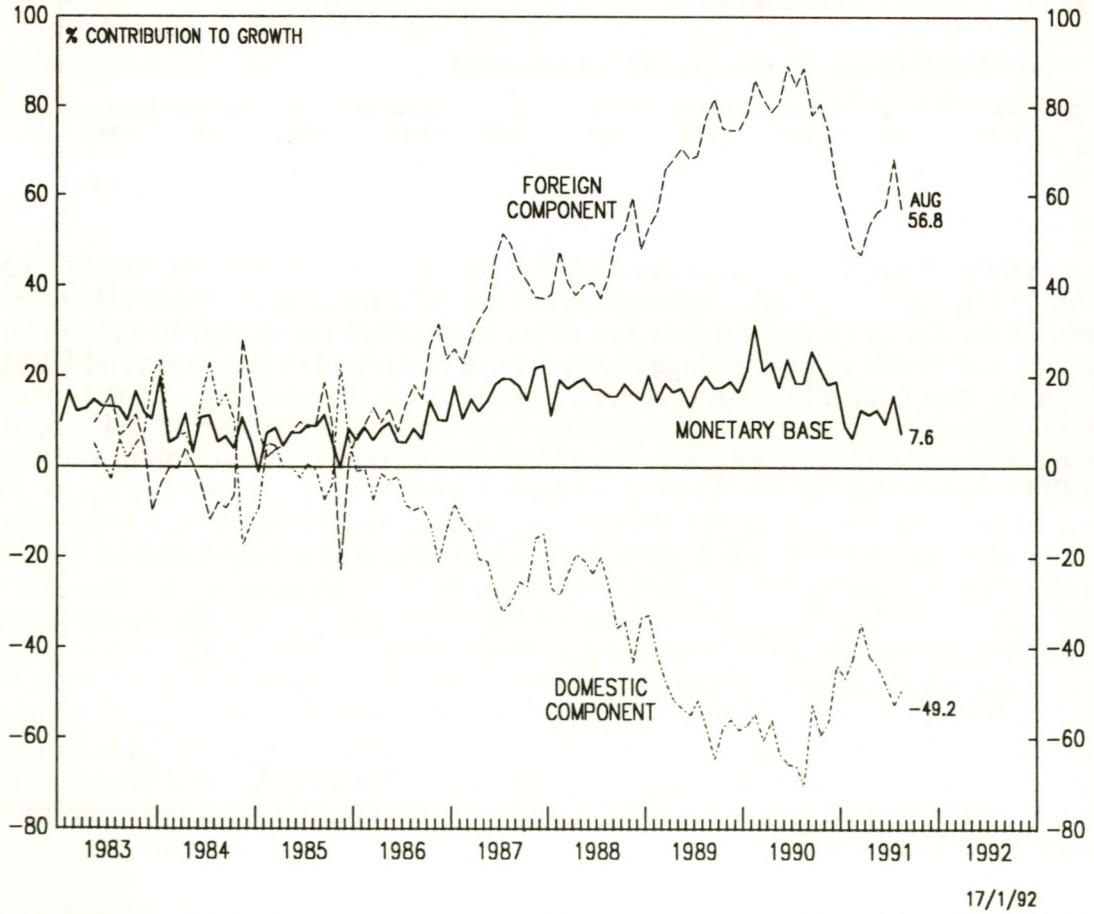


A large cyclical current account deficit is not in itself a problem as long as it can be funded by capital inflows. Fortunately, this has been the case in Thailand in recent years where the net capital inflow has more than offset the deficit in the current account, and thus foreign exchange reserves have continued to rise to around US$17 billion, or over 6 months' import cover. However, it is the changing shape of these capital inflows that gives rise to the greatest cause for concern (Chart 10). There are three components of these inflows -- direct investment, portfolio investment and what the BOT calls "other loans." The first of these components has slowed dramatically from Baht 15 billion during Q4 1990 to only Baht 2 billion during Q3 1991. This reflects the slowdown in the Japanese economy and is the major reason for the deceleration in imports. The second component, portfolio investment, has also all but dried up over 1991 as the Thai stockmarket has tracked sideways. The result is that the current account deficit is now being almost entirely funded by the "other loans" component which is 75% offshore borrowing -- mainly short term -- and 25% non-resident Baht accounts. Because of the de facto peg of the Baht to the US$ in place since 1985 (Chart 11), Thai and non-resident entities have been tempted to borrow US$, lend Baht and take advantage of the differential between US and Thai interest rates. With little prospect of a significant increase in direct or portfolio investment during 1992, Baht stability is therefore essential to prevent capital flight.

Fundamentally, the Baht does not appear to be overvalued against the US$, a proposition supported by the continued robust performance of Thai exports. A PPP analysis based on consumer prices yields a fair valuation while the use of a tradeables price index suggests the Baht may be around 20% undervalued. Nevertheless, should the balance of payments surplus move into deficit -- for example, due to large scale repayments of offshore borrowing -- then the Baht could come under downward pressure despite its fundamental valuation. Signs of Baht weakness would encourage further capital flight and a downward spiral could develop. Given the BOT's commitment to the currency peg, it would be compelled to use its pool of foreign exchange reserves to defend the currency and would probably have to raise interest rates again.

SUMMARY AND CONCLUSION: Although the trend in Thai interest rates is clearly down, a number of factors point towards a reversal of this trend. What is unclear however, is when this reversal will occur. It is certainly true that the economy has weakened relative to the period 1988-90, but a range of indicators show the economy to be robust and in some cases starting to rebound. Inflation remains around 6%, imports have only recently slowed, the current account deficit is 8.5% of GDP and money and credit growth may well be starting to turn up again. The recent falls in interest rates could therefore fuel a resurgence in inflationary pressures and import demand, and thus lead to a renewed tightening of monetary policy.

THAILAND: CHART 12
SOURCES OF MONETARY EXPANSION

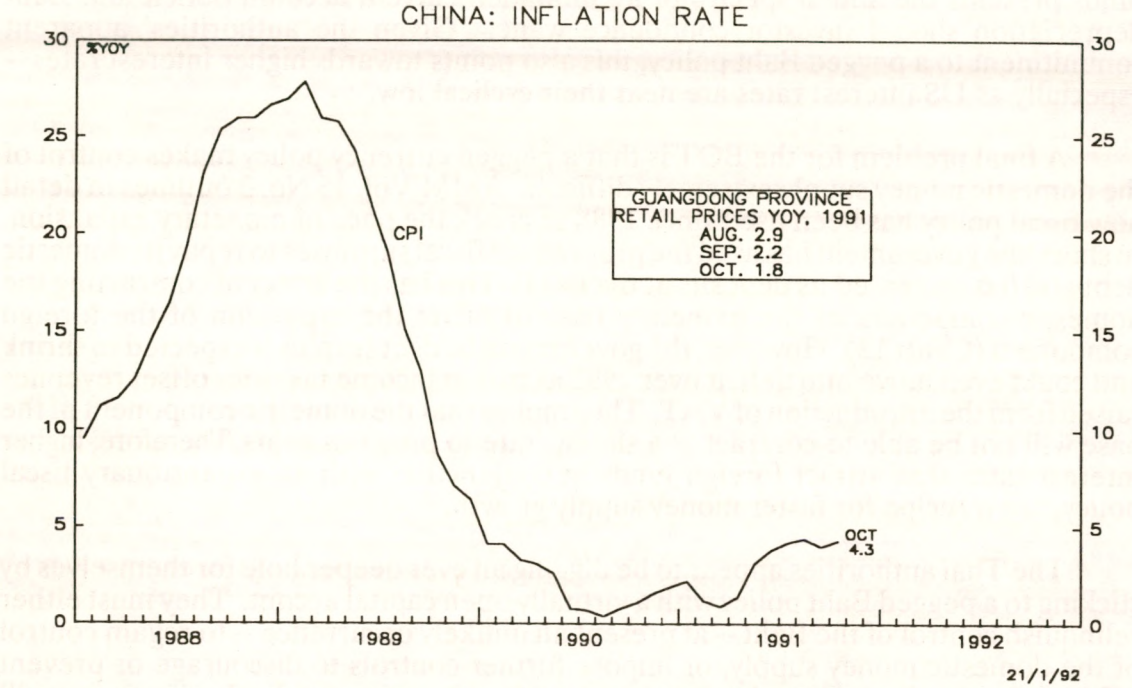


Separately, the shifting pattern of capital inflows towards short term, speculative funds presents the added spectre of an unfunded current account deficit and Baht depreciation should investor confidence wane. Given the authorities' apparent commitment to a pegged Baht policy, this also points towards higher interest rates -- especially as US interest rates are near their cyclical low.

A final problem for the BOT is that a pegged currency policy makes control of the domestic money supply extremely difficult. AMM Vol. 15 No. 3 outlines in detail how fiscal policy has been used since 1988 to check the pace of monetary expansion. In short, the government has used the proceeds of fiscal surpluses to repay its domestic debt and has increased its deposits at the BOT. This has the effect of contracting the domestic component of the monetary base to offset the expansion of the foreign component (Chart 12). However, the government budget surplus is expected to shrink and could even move into deficit over 1992 as cuts in income tax rates offset revenues raised from the introduction of VAT. This implies that the domestic component of the base will not be able to contract at a similar rate to previous years. Therefore, higher interest rates that attract foreign funds in conjunction with an expansionary fiscal policy, are a recipe for faster money supply growth.

The Thai authorities appear to be digging an ever deeper hole for themselves by sticking to a pegged Baht policy with a virtually open capital accont. They must either relinquish control of the Baht -- at present an unlikely occurrence -- to regain control of the domestic money supply, or impose further controls to discourage or prevent offshore borrowing. Even in the absence of such action, cyclical adjustment will continue to be a drawn-out affair while the BOT pursues its growth-oriented policies. Recent history suggests therefore, that any renewed monetary tightening will be delayed as long as possible.

CHINA: MIXED ECONOMIC NEWS

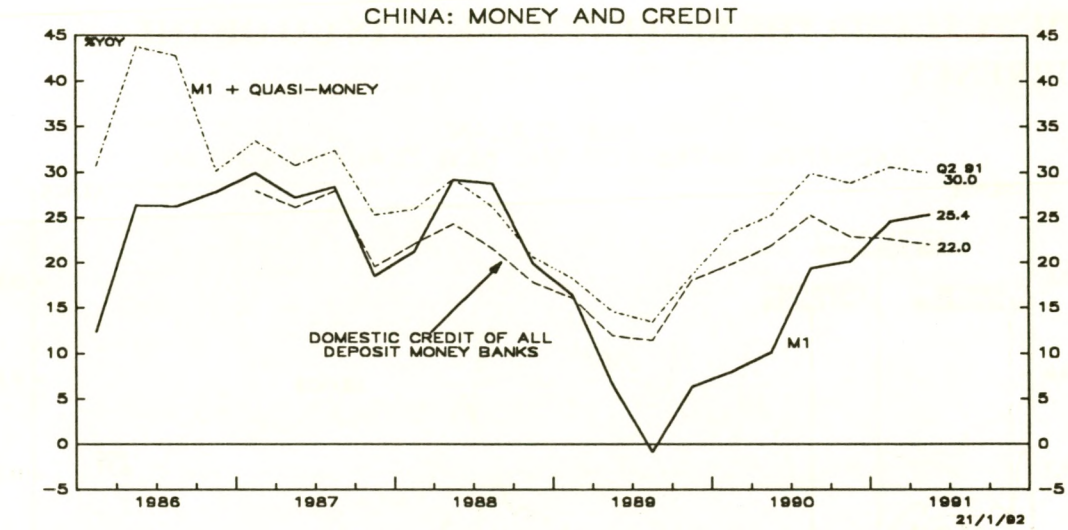


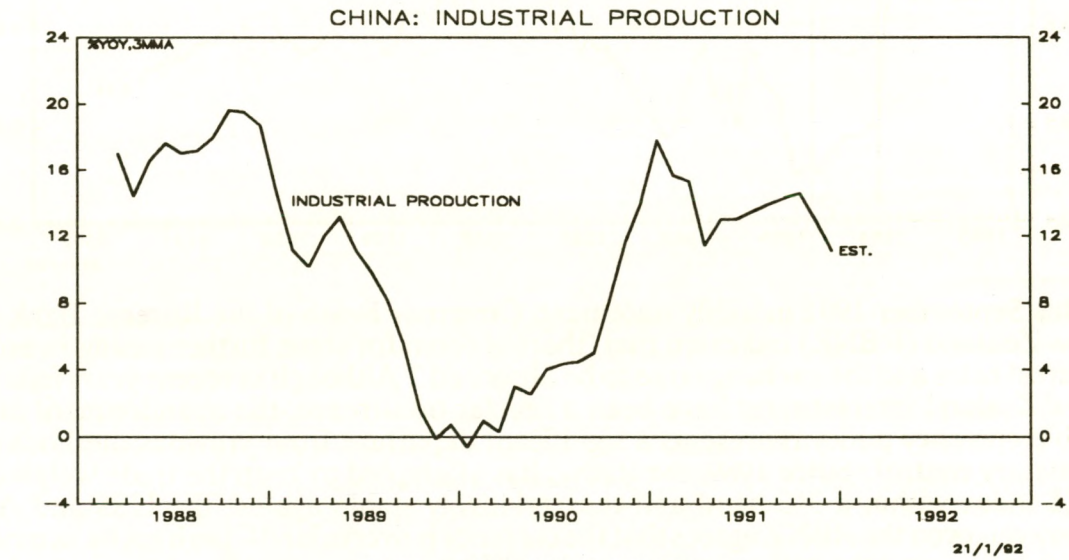
The successful conclusion in January 1992 of the "Special 301" trade negotiations with the US averted a damaging tariff war between the two countries. Having cleared the hurdle of the intellectual property rights, the two sides will now have to negotiate the issues of the straight 301 (market access to China) and then the extension of China's Most Favoured Nation (MFN) status.

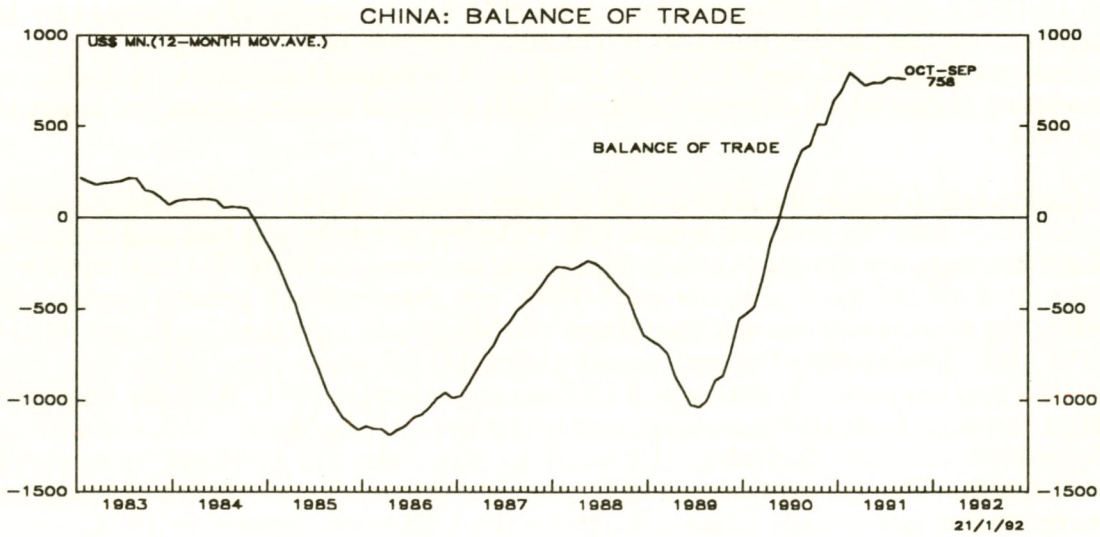
As the chart above indicates, measured inflationary pressures in China do not show a marked rising trend, although anecdotal evidence of price rises in urban centres points to inflation rates of nearly double those of the broad CPI or of those in the Guangdong province. Money stock growth (top chart opposite page) still remains high. The central authorities are growing concerned over the mounting state budget deficit. Since June 1991 there has been a selective credit squeeze, which was extended nationwide as from the start of 1992, in order to contain the growth of bank loans. The Chinese authorities have shown themselves capable of imposing a very tight credit squeeze, as they did from 1988 Q2 to 1989 Q3 when inflation appeared to be getting out of hand. The imposition of this credit restraint has already affected the growth of industrial output (middle chart, opposite page). GDP grew at 6.8% during the first nine months of 1991 with industrial output growing at nearly 14% during the first 10 months of 1991. The current slowdown is undesirable but necessary if the economy is to be stopped from overheating yet again.

Since the middle of 1990 the trade balance has been maintained at a healthy surplus with external reserves rising to a record level of US$40 bn during 1991 (bottom chart, opposite page). The Chinese authorities have announced that they are planning to let the yuan float and unify the existing multiple exchange rates.

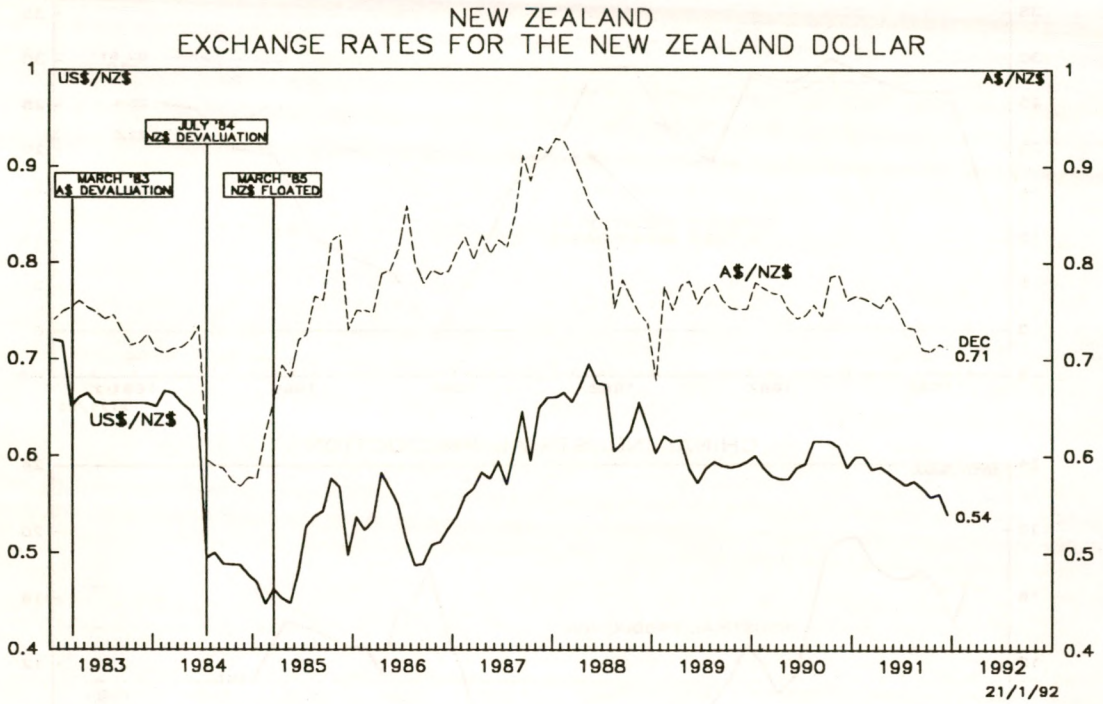
Subject to the credit squeeze being maintained, the economy will slow down during 1992 but inflationary pressures will still be in evidence.


CHINA: MONEY AND CREDIT
%YOY
M1 + QUASI-MONEY
Q2 91
30.0
25.4
22.0
DOMESTIC CREDIT OF ALL
DEPOSIT MONEY BANKS
M1
45
40
35
30
25
20
15
10
5
0
-5
1986
1987
1988
1989
1990
1991
21/1/92


CHINA: INDUSTRIAL PRODUCTION
%YOY,3MMA
INDUSTRIAL PRODUCTION
EST.
24
20
16
12
8
4
0
-4
1988
1989
1990
1991
1992
21/1/92

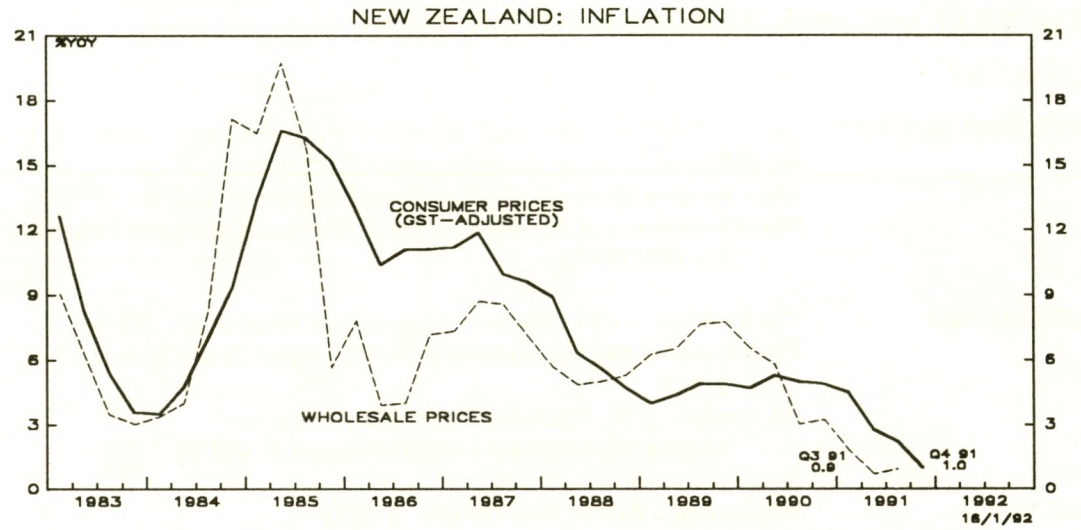

CHINA: BALANCE OF TRADE
US$ MN.(12-MONTH MOV.AVE.)
OCT-SEP
758
BALANCE OF TRADE
1000
500
0
-500
-1000
-1500
1983
1984
1985
1986
1987
1988
1989
1990
1991
1992
21/1/92

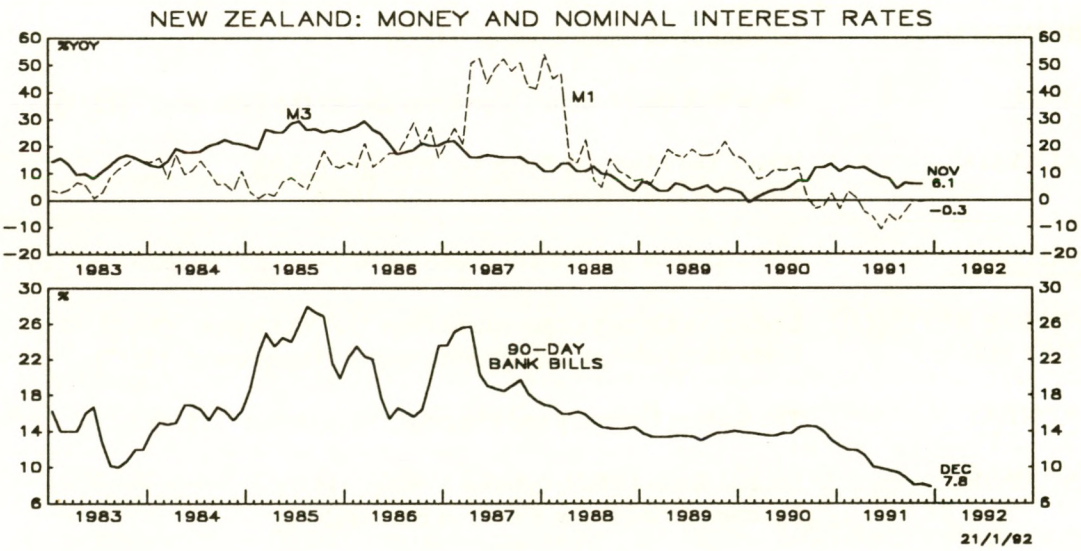
NEW ZEALAND: THE RESERVE BANK LETS GO OF THE CURRENCY

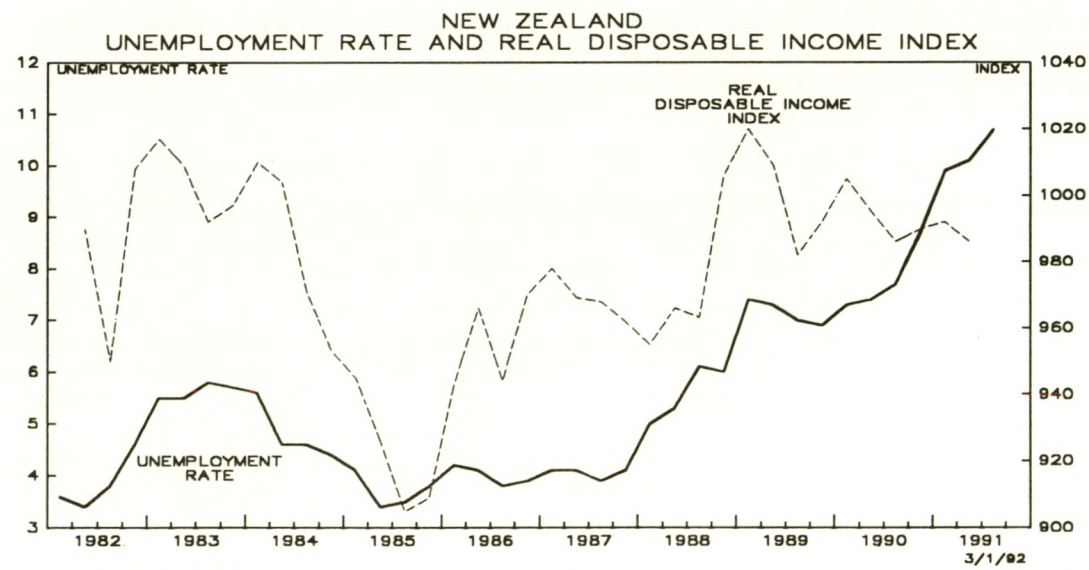


In his September 1991 monthly statement, Governor Brash of the Reserve Bank of New Zealand (RBNZ) indicated that "there is room for some further easing in both interest rates and the exchange rate to be absorbed." Although in recent years falls in New Zealand interest rates have been a regular occurrence, the abandonment of a stable currency policy represents a significant departure from previous methods of monetary control. Since 1989, the RBNZ has attempted to keep the trade weighted NZ$ index within a 3% band and thus relatively stable against the US$ and A$. However, even the RBNZ agrees that the currency is overvalued -- perhaps by as much as 10-15% -- and the attempt to target the NZ$ at an overvalued exchange rate has kept interest rates higher than they might otherwise have been. Therefore by relaxing its control of the NZ$, the RBNZ has given itself increased flexibility in its conduct of monetary policy which can now be more easily directed towards domestic policy objectives.

Inflation fell to within the RBNZ's 0-2% target during Q4 1991 -- a full year ahead of schedule -- and the concern is now that inflation is falling too fast and creating a disinflationary environment that is depressing economic activity. Interest rates have continued to fall precipitiously over 1991, but nominal M1 growth remains flat reflecting weakness in current spending while M3 growth has fallen back from its early 1991 high. This mirrors the performance of real GDP which is no higher than it was in 1985 and has probably contracted 1.8% during calendar 1991. With the unemployment rate already at 10.7% and expected to rise to 13.1% by March 1993, and with real disposable incomes declining, the need to stimulate the economy is becoming paramount. This points towards still lower interest rates and further slippage in a currency that has already fallen 6% against the US$ since September 1991.


NEW ZEALAND: INFLATION
%YOY
CONSUMER PRICES
(GST-ADJUSTED)
WHOLESALE PRICES
Q3 91
0.9
Q4 91
1.0
1983
1984
1985
1986
1987
1988
1989
1990
1991
1992
16/1/92


NEW ZEALAND: MONEY AND NOMINAL INTEREST RATES
%YOY
M3
M1
NOV
6.1
-0.3
%
90-DAY
BANK BILLS
DEC
7.8
1983
1984
1985
1986
1987
1988
1989
1990
1991
1992
21/1/92


NEW ZEALAND
UNEMPLOYMENT RATE AND REAL DISPOSABLE INCOME INDEX
UNEMPLOYMENT RATE
INDEX
REAL
DISPOSABLE INCOME
INDEX
UNEMPLOYMENT
RATE
1982
1983
1984
1985
1986
1987
1988
1989
1990
1991
3/1/92

AN INDEX OF AMM ARTICLES PUBLISHED IN VOLUME 15

REGIONAL SURVEY:	Interest Rates, the Business Cycle and Foreign Exchange Policy (15/1) What Rationale for an Asian Regional Trade Bloc? (15/5) The Changing Structure of Asian Export Exposure (15/5) North East Asian and South East Asian Business Cycles and Prospects for 1992 (15/6)
HONG KONG:	The Problem of CPI Inflation - Monetary or Structural? (15/3) The Dynamics and Significance of the Re-Export Trade With the PRC (15/5) An Analysis of the Exchange Fund Bills Programme: Market Microstructure and Performance (15/6)
INDIA:	Politics and a Tale of Two Deficits (15/1)
INDONESIA:	Inflation Back under Control (15/3)
JAPAN:	When Will the Monetary Slowdown Impact the Economy? (15/4)
MALAYSIA:	Where Did Monetary Policy Go Wrong? (15/1) Monetary Policy Remains too Loose (15/6)
PAKISTAN:	Embarking on the Road of Economic Reform and Deregulation (15/4)
PEOPLE'S REPUBLIC OF CHINA:	Update on China's Economic Reform: the 7th Plenum (15/2) Enterprise Reforms and Macroeconomic Management (15/2)
S. KOREA:	The Stalling Economy and Financial Deregulation (15/4)
SINGAPORE:	Interest Rates to Fall, Inflation to Rise (15/2) Economy Slows Down, Credit to Ease (15/6)
TAIWAN:	Fixed Investment Growth is the Key to Economic Recovery (15/2)
THAILAND:	Fiscal Policy Has Restrained Monetary Expansion (15/3)

ECONOMIC CAPSULES:

AUSTRALIA:	Continuous Easing of Monetary Policy (15/1) Still in Recession but some Good News Is Emerging (15/3) The Australia-New Zealand CER Trade Agreement (15/5)
CHINA:	The MFN Questions (15/5)
HONG KONG:	The Real Truth Behind the Export Figures (15/1)
INDIA:	New Government, Same Old Problems (15/4)
INDONESIA:	Further Moves to Drain Liquidity (15/2)
JAPAN:	The Monetary Squeeze and Interest Rates (15/2)
MALAYSIA:	Symptoms of Overheating Persist (15/4)
NEW ZEALAND:	Labour Market Reform - The Last Piece in the Jigsaw of Deregulation (15/3)
PHILIPPINES:	Caution Advised (15/2) Natural and Manmade Disruptions (15/4)
SOUTH KOREA:	Treating the Symptoms not the Causes (15/1)

AMM March-April 1992 Vol. 16 No.2

ASIAN MONETARY MONITOR

CONTENTS

Page

REGIONAL SURVEY

Quantifying the Characteristics of Emerging Asian Equity Markets 1
by Andrew Freris

JAPAN

How Long Can the Current Account Surplus Be Recycled at Present Exchange Rates? 15
by John Greenwood

SOUTH KOREA

Stabilisation before Liberalisation 21
by Simon Ogus

ECONOMIC CAPSULE

Malaysia: A Reversal in Exchange Rate Policy SLO 32

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ASIAN MONETARY MONITOR

March-April 1992 **Vol. 16 No.2**

REGIONAL SURVEY: QUANTIFYING THE CHARACTERISTICS OF EMERGING ASIAN EQUITY MARKETS

Introduction

Since the late 1980s a great deal of attention has been paid to the investment opportunities offered in the so-called Emerging Equity Markets (EEM). The question however, of what constitutes EEMs, and what factors determine their development and growth are still largely unexplored and under-researched.

For purely formal classification purposes an EEM is a market which is included in the statistical returns, indices and publications of the International Finance Corporation (IFC), an institution of the World Bank.

At present the following eight Asian equity markets are included in this classification:

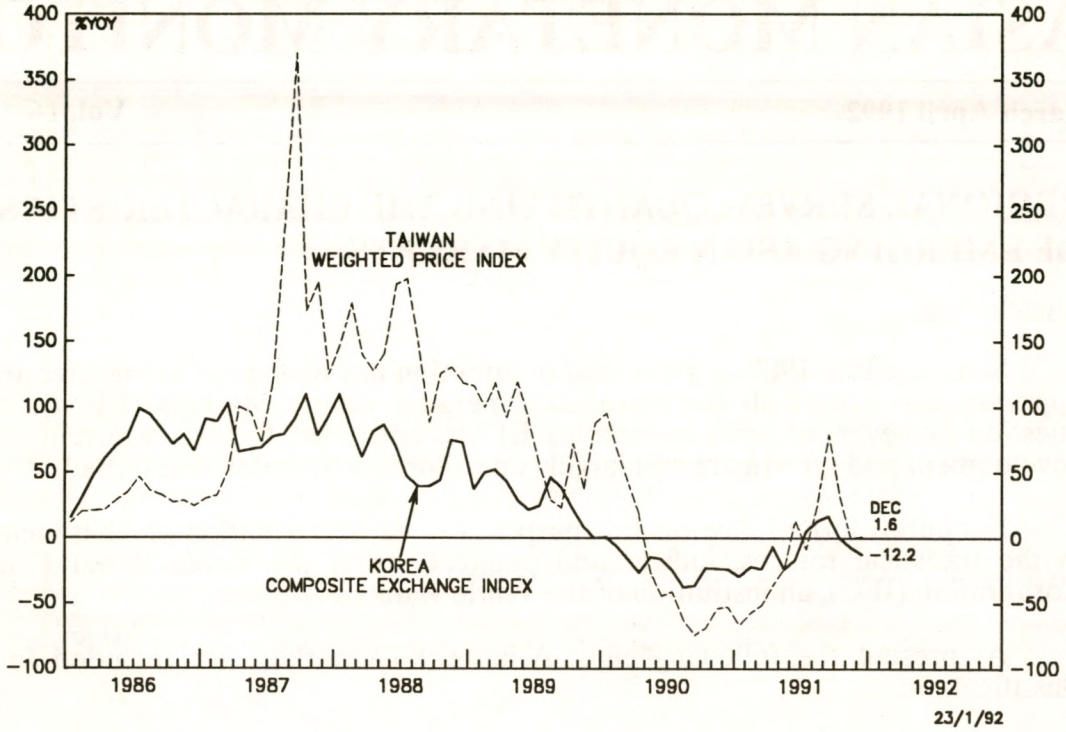
East Asia: South Korea, Philippines, Taiwan
South Asia: India, Indonesia, Malaysia, Pakistan, Thailand

Undoubtedly opinions would differ whether the classification of Korea and Taiwan as emerging markets is either correct or appropriate. Similarly there are, at present, no clear cut criteria as to the stage of development that would qualify a market for inclusion in the EEMs or for graduation to the ranks of the fully emerged and developed markets. These questions are of importance not only for purely classification purposes, but also because they impinge directly on crucial issues of financial development and on the role of equity markets in the economies of developing countries. The dynamics and patterns of growth of EEMs are also of importance in the construction of diversified portfolios and hence to overall financial investment policies.

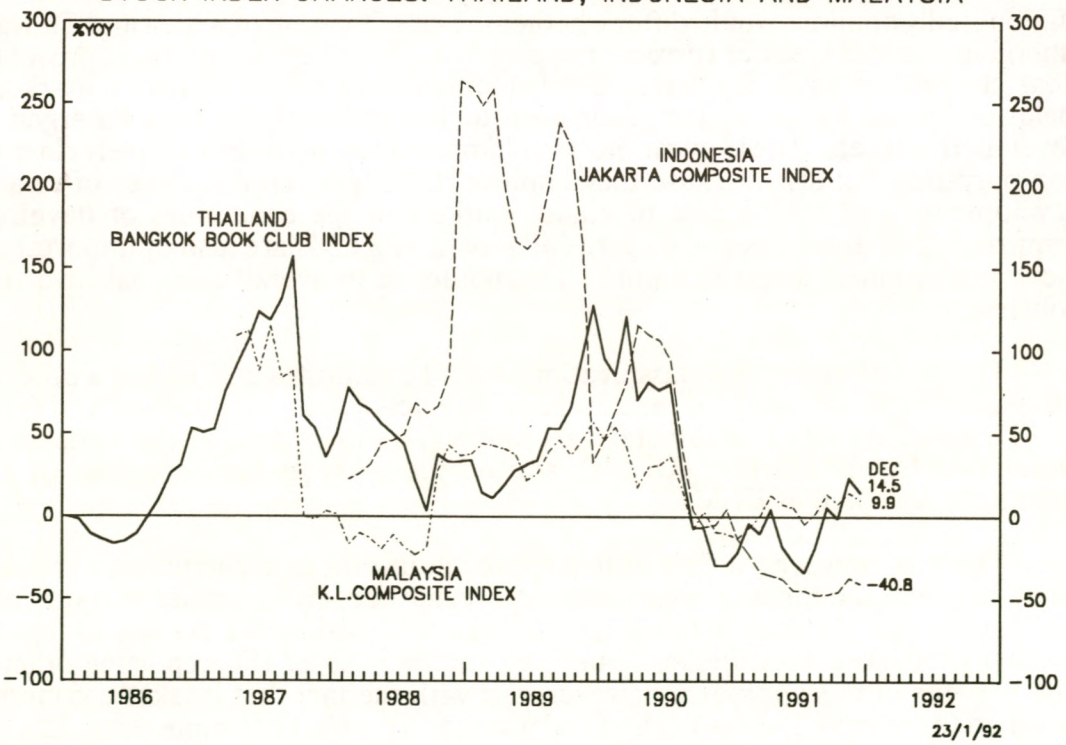
This article attempts a classification of what constitutes an EEM by a process of comparative quantification of certain characteristics of market behaviour and dynamics. By necessity this exercise starts by looking, on one hand, at the behaviour of Developed Equity Markets (DEMs), and on the other at the behaviour of those commonly accepted as EEMs.

There is, however, a flaw in this approach insofar as a comparison should be made between the three or four major equity markets and all other markets in the world. The sample used in this article is already biased by the act of picking out a number of markets classified as "emerging" on the basis of IFC reporting practices. The benefits of this approach, however, rest with the fact that it takes a commonly assumed (or accepted) classification and puts it to a number of simple tests. The basic question, therefore, is whether there are enough differences in the structure and patterns of behaviour of these markets to set them apart from other developed ones.

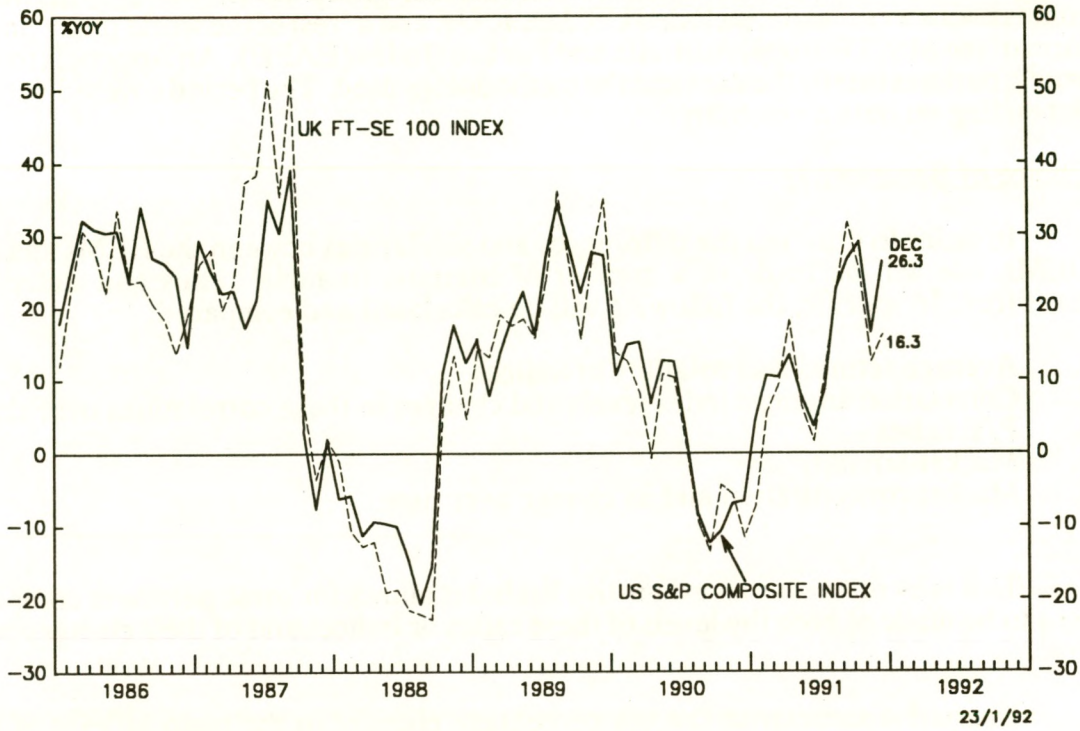
REGIONAL SURVEY: CHART 1
STOCK INDEX CHANGES: KOREA AND TAIWAN



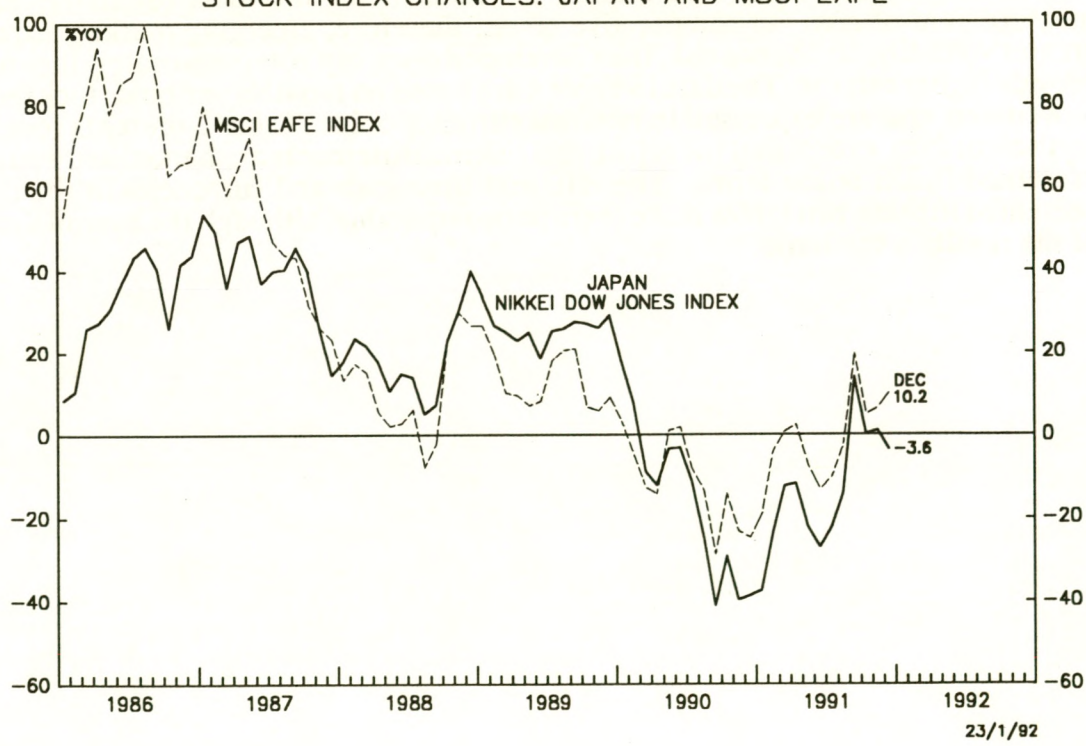
REGIONAL SURVEY: CHART 2
STOCK INDEX CHANGES: THAILAND, INDONESIA AND MALAYSIA



REGIONAL SURVEY: CHART 3
STOCK INDEX CHANGES: US AND THE UK



REGIONAL SURVEY: CHART 4
STOCK INDEX CHANGES: JAPAN AND MSCI EAFE



The coverage of the survey of EEMs was limited to five: Korea, Taiwan, Malaysia, Thailand and Indonesia. The control group of DEMs against which comparisons were made, included US, Japan, UK and a "rest of the world proxy" in the form of the MSCI Europe, Australia and Far East Index (EAFE). An Appendix to this article outlines briefly the data and the methodology used. The period covered varied, depending on data availability.

Choice of Benchmarks

In order to draw out the differences and similarities beween the EEMs and the DEMs, use will be made of a number of common financial ratios and statistical measures. In specific, the following will be calculated and compared:

1. Average returns and volatility of indices
2. Correlation amongst index levels and changes in these correlations over time
3. P/E ratios
4. Market liquidity
5. Market concentration and its change over time

This is by no means an exhaustive list but it allows for some pertinent comparisons to be made of both the levels of these ratios or indices and of their changes over time.

Charts 1-4 summarise the yoy percentage changes in the main indexes of the countries involved. Table 1 also shows key statistical measurements of these changes. The emerging markets indices show greater volatility both in terms of higher average returns and larger standard deviations, the latter being the most commonly used measurement of risk. In comparative terms, therefore, emerging markets exhibit greater volatility, and hence risk, than developed ones, but commensurately they also provide higher returns. The data in Table 1 are based on monthly national stock index movements and are expressed in national currency units. Table 2 presents roughly equivalent data, except that the return and risk measurements are annualised and are presented in US dollar terms. The different time span and currencies in the data presented in these two tables make them noncomparable, although the overall thrust of the results is the same.

Table 1

Comparative Returns and Standard Deviations

Country and index	Return	Standard Deviation
US (S+P 500) (1986)	13.65	14.91
UK (FT 100) (1986)	12.55	17.06
Japan (Nikkei) (1986)	14.65	24.87
EAFE (MSCI))(1986)	24.02	33.75
Korea (Composite) (1986)	36.45	43.10
Taiwan (Weighted) (1987)	67.05	90.62
Malaysia (KL Composite) (1987)	24.34	33.87
Thailand (Bangkok Book Club) (1986)	36.85	44.76
Indonesia (Jakarta Composite) (1989)	71.33	108.65

NB: Returns are yoy percentage index changes based on monthly data with the standard deviation calculated over the sample period used. The period covered varied, depending on index data availability, from 1/1/86 to 1/1/92.
The dates in the brackets indicate the starting year of coverage as appropriate.

Table 2

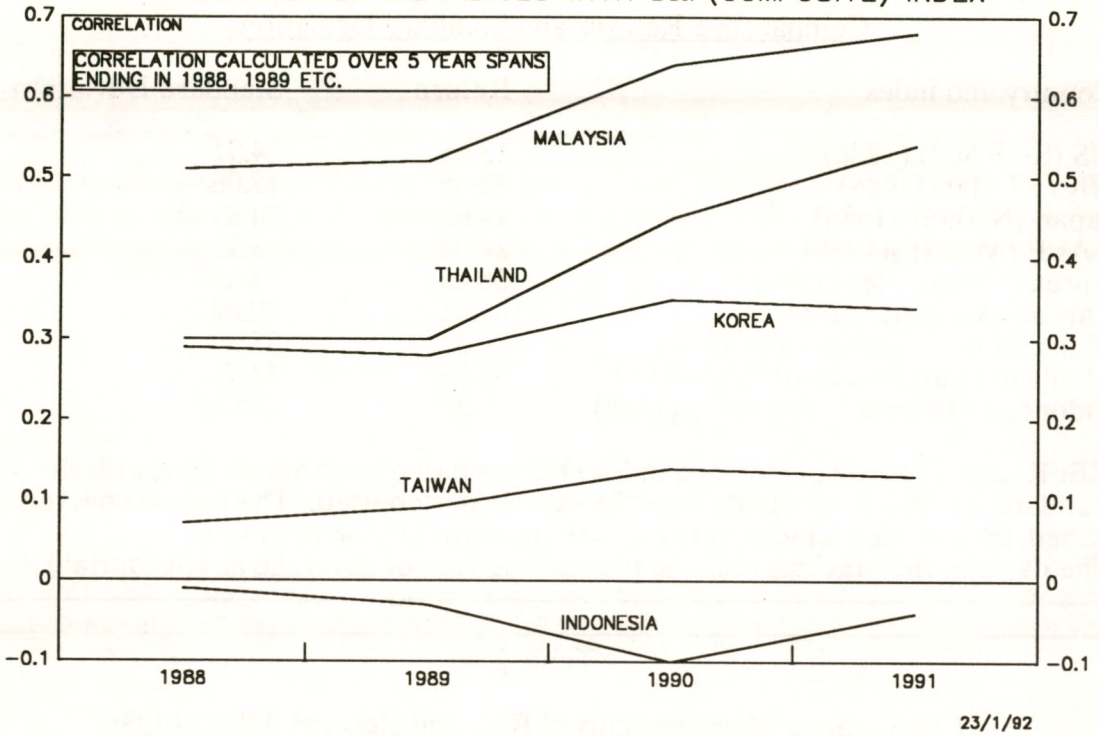
Comparative Measurements of Risk and Reward, 1986-91 Q3
(Monthly data, annualised)

Country and Index	Average Return (%)	Standard Deviation	Return per Unit of Risk (*)
US (S&P 500)	12.1	18.1	0.66
UK (FT 100)	16.8	22.5	0.74
Japan (Nikkei)	12.9	28.0	0.46
EAFE (MSCI)	9.7	21.8	0.44
Korea (IFC)	15.1	26.6	0.56
Taiwan (IFC)	51.7	63.9	0.80
Malaysia (IFC)	14.6	29.1	0.50
Thailand (IFC)	24.8	33.2	0.74
Indonesia (IFC)	-27.7	35.1	-0.78

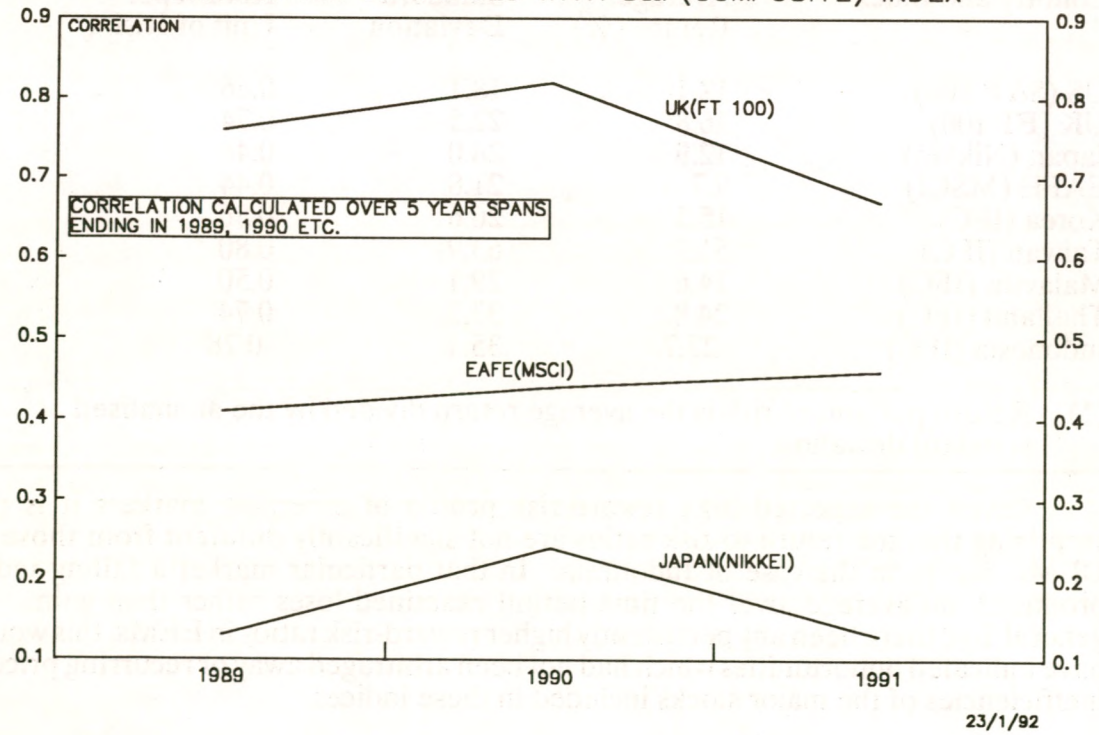
(*) Return per unit of risk is the average return divided by the annualised standard deviation.

Given the expected high reward-risk profile of emerging markets it is not surprising that the return to risk ratios are not significantly different from those of DEMs, except in the case of Indonesia. In that particular market a falling index produced, on average, over the time period examined loses rather than gains. In general, had there been any persistently higher reward-risk ratios in EEMs, this would have indicated opportunities which had not been arbitraged away or recurring pricing inefficiencies of the major stocks included in these indices.

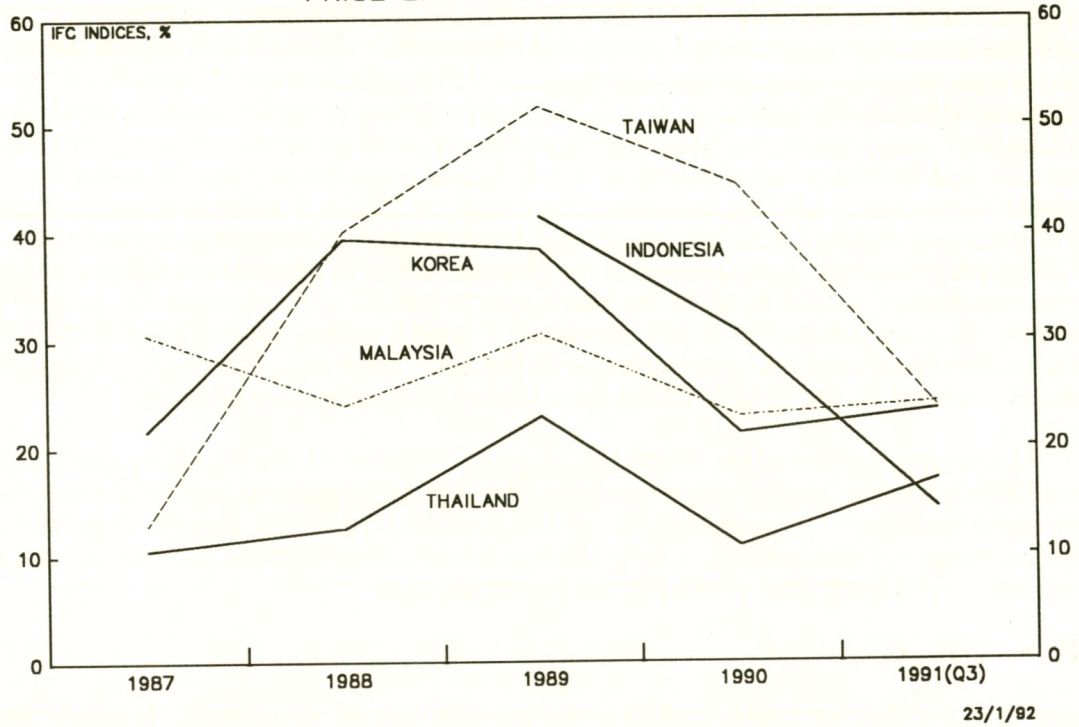
REGIONAL SURVEY: CHART 5
CORRELATION OF IFC INDICES WITH S&P(COMPOSITE) INDEX



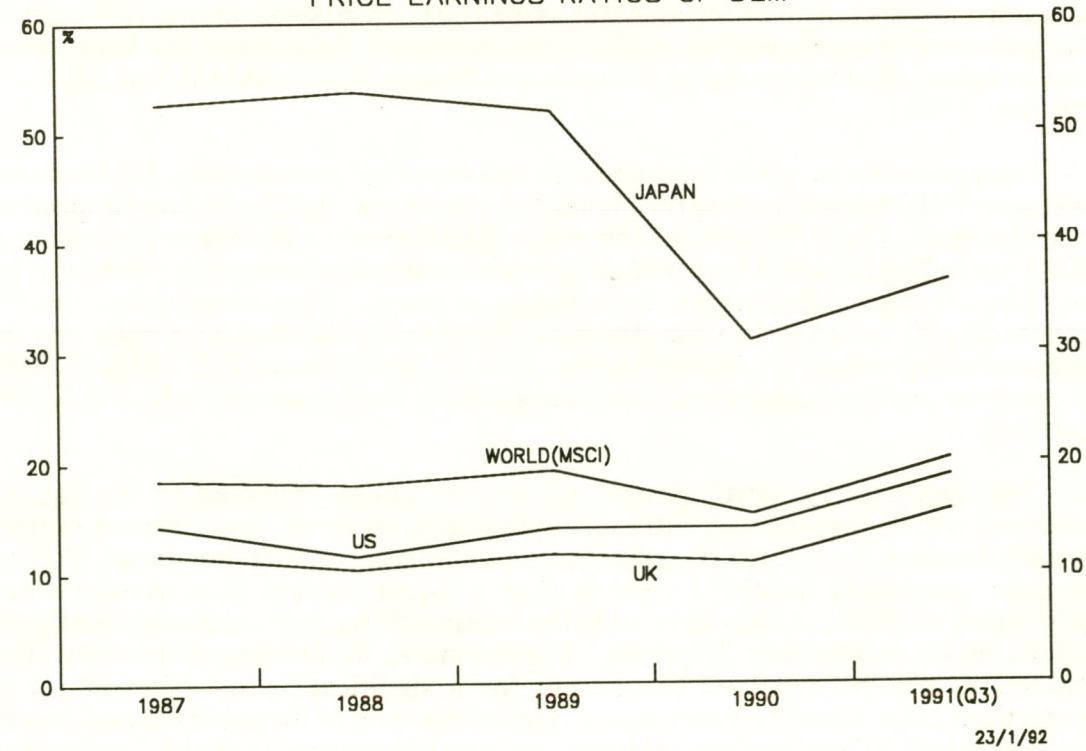
REGIONAL SURVEY: CHART 6
CORRELATION OF INDICES WITH S&P(COMPOSITE) INDEX



REGIONAL SURVEY: CHART 7
PRICE EARNINGS RATIOS OF EEM



REGIONAL SURVEY: CHART 8
PRICE EARNINGS RATIOS OF DEM



The higher volatility of the EEMs, however, is combined with relatively low correlation with the index levels of their developed counterparts. As Chart 5 shows two of the countries in question Taiwan and Indonesia, exhibited low, and in the case of Indonesia negative correlation with the main US equity market. Shares from these EEMs would be ideally suited for diversification purposes in portfolios which included equities from major markets. Movements in the prices of these shares would not have been affected by index movements in the US, and even better, would move in the opposite direction. All the countries surveyed in Chart 5 exhibit broadly rising correlation coefficients which is as should be expected. Over time these markets would be progressively integrated with the global trading of securities and hence their index movements would tend to be more synchronised with the rest of the world markets. Having pointed this out, however, is worth noting from Chart 6 that the Nikkei index has a very low correlation with the S&P 500 index, although UK and the markets covered by the EAFE index have higher correlation coefficients.

The interpretation of the Price Earning (P/E) ratios of the EEMs against those of the DEMs is considerably more complex. P/E ratios, in general, reflect the interest rates used to discount expected earnings (or dividends) and the expected growth of these earnings (or dividends). Using the basic valuation formula for the stream of dividends over a long time period it can be shown that

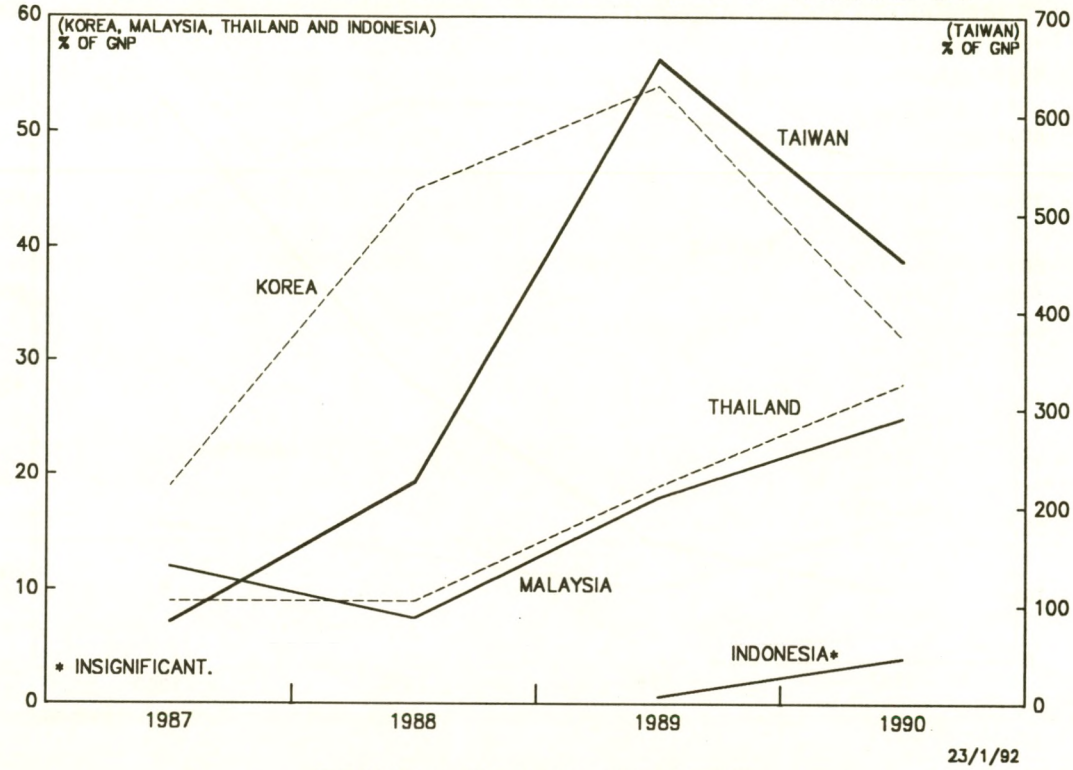
$$P/E = 1/R - G$$

where R is the discount rate, and G is the growth rate of dividends. It would now follow that differences in the P/E ratios reflected differences in the appropriate R and G values for each market. There are, however, other factors which need to be taken into account. For example, the R used for discounting contains two elements. Firstly, the opportunity cost of investing in shares as measured by riskless returns such as those from government bonds and, secondly, a risk premium. Measuring the later can be quite complex. (For an extensive discussion of these issues see AMM Vol. 14, No. 3, May-June 1990.)

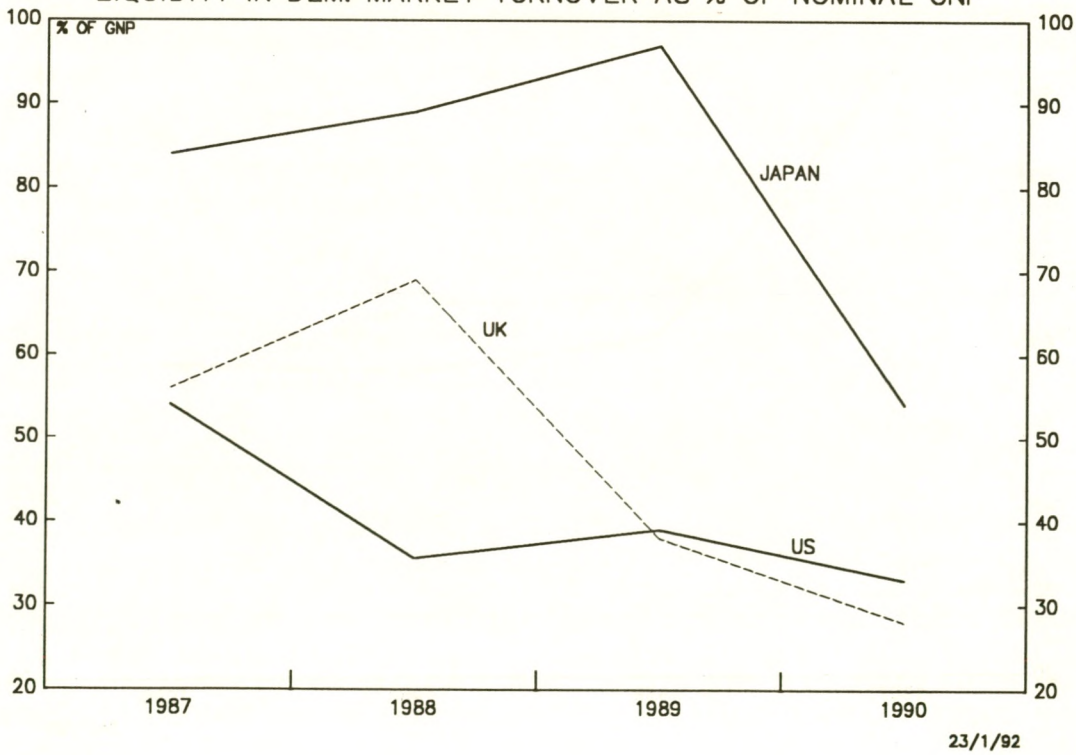
On a priori basis, given interest rates and expected growth rates, EEMs would have lower P/E ratios reflecting the higher risk premiums. As Charts 7 and 8 show this is not the case. The P/E ratios of the Asian EEMs tend to be higher than those of DEMs, excluding Japan. This could be the result not just of lower risk premiums but also of higher expected earning or dividend growth rates. These conclusions must be tempered by the fact that the valuation model used to derive them is a simple one and hence can only produce broad conclusions. Overall, however, the P/E ratios of EEMs did not show any particular trend over the relatively short time over which they were examined.

The degree of the development of a market will be reflected on the liquidity conditions within that market. Measuring liquidity, however, is an inexact exercise precisely because liquidity can be taken to mean a number of different things. Perhaps the most commonly accepted view is that a liquid market is a market where transactions of different sizes in most of the commonly traded shares can be effected without major movements in prices. Furthermore, in developed markets share transactions can be expected to account for a significant proportion of <u>all</u> the transactions undertaken in the economy. Hence the ratio of the value of stock market transaction to GNP can be deemed to be a reasonable proxy of both the development

REGIONAL SURVEY: CHART 9
LIQUIDITY IN EEM: MARKET TURNOVER AS % OF NOMINAL GNP

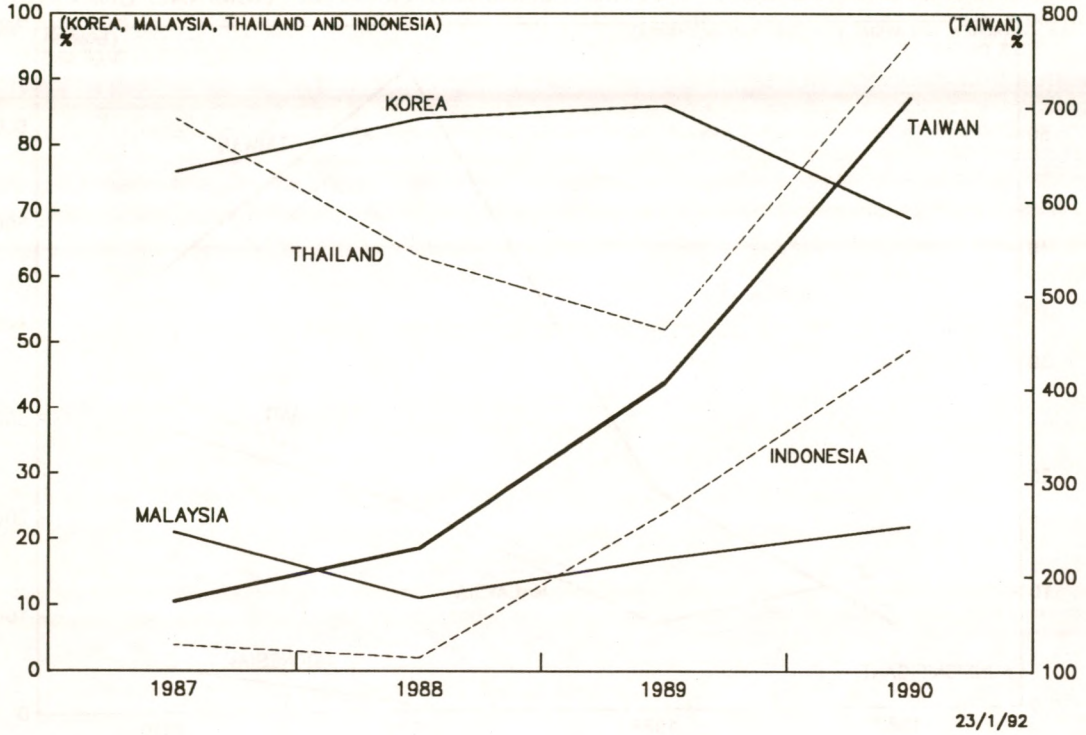


REGIONAL SURVEY: CHART 10
LIQUIDITY IN DEM: MARKET TURNOVER AS % OF NOMINAL GNP



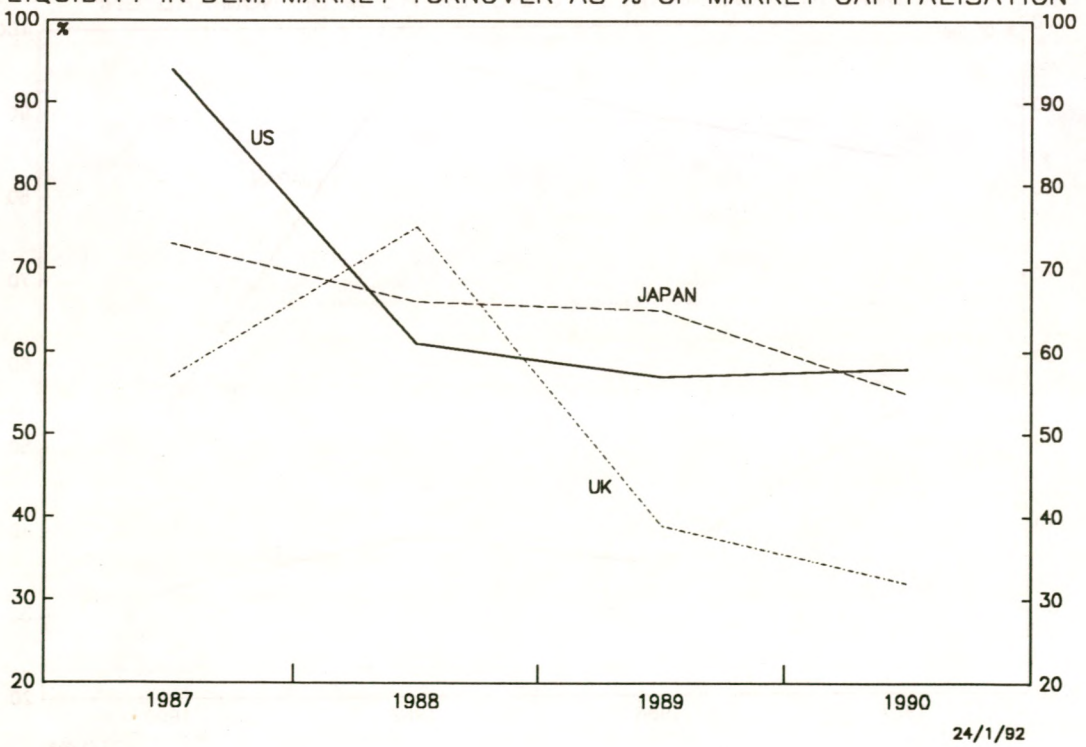
REGIONAL SURVEY: CHART 11

LIQUIDITY IN EEM: MARKET TURNOVER AS % OF MARKET CAPITALISATION



REGIONAL SURVEY: CHART 12

LIQUIDITY IN DEM: MARKET TURNOVER AS % OF MARKET CAPITALISATION



of the market and, by extension, of its liquidity. Another ratio, that of transactions to market capitalisation, is less useful as an index of liquidity or of market development. This ratio divides a flow variable (transactions) with a stock variable (market capitalisation). The value of transactions has a time dimension, ie transactions per time period, whereas that of the market capitalisation does not, as it is measured at a single moment in time. Keeping this caveat in mind Charts 9-12 show the relevant ratios for the EEMs and DEMs.

With the exception of Taiwan, the EEMs tended to have in general lower ratios than those of developed markets. This is particularly true when the more relevant, and analytically correct, ratio of Market Turnover to GNP is used. There are no obvious variations over time in these ratios either for the developed or for the emerging markets. There are exceptions, however, particularly when equity markets experience sudden increases in turnover or in the number of shares quoted. Indonesia and Thailand are cases in mind. Both markets "took off" after 1987. Previous to that, and in particular in the case of Indonesia, the activities in the market were effectively negligible.

The final market characteristic concerns the degree of market concentration in terms of the market capitalisation per quoted company and the share of market capitalisation by the largest listed companies.

Charts 13 to 14 indicate that most of the EEMs exhibit a low capitalisation value per company, with Taiwan being the exception Not surprisingly over time the capitalisation per company rose for most of the EEMs whereas it stayed relatively static for the DEMs. It is important to point out that the actual number of companies in the EEMs tended to increase whereas those in developed markets remained relatively unchanged (Table 3). The process of economic and financial development in the EEMs caused the average size of listed companies to increase during a time when the total number of companies also rose.

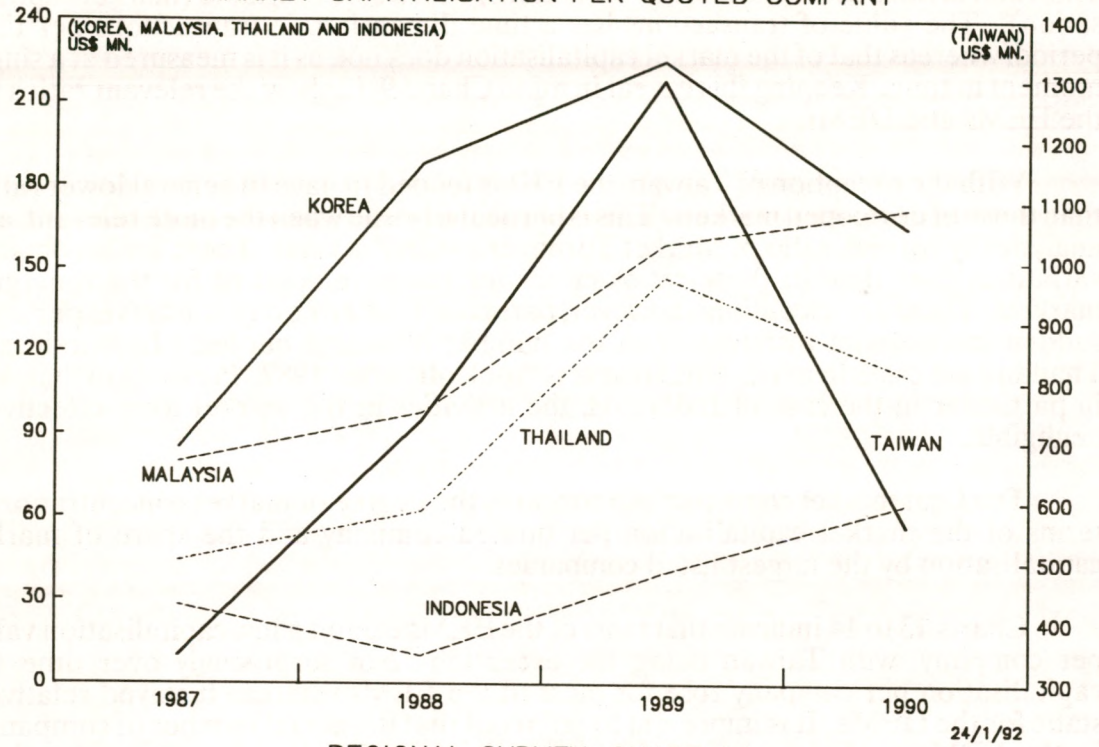
Table 3

Average annual percentage change in the number of domestic listed companies 1986-1990

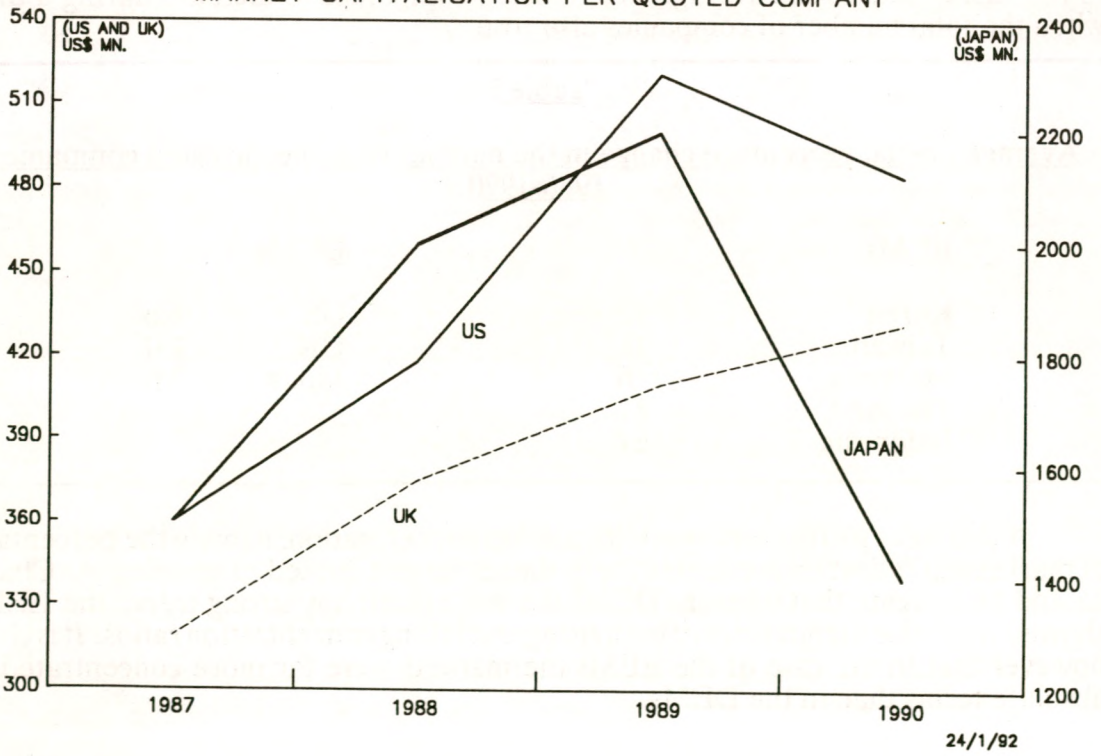
EEMs		DEMs	
Korea	17	US	-6.6
Taiwan	11	UK	1.0
Malaysia	6	Japan	2.6
Thailand	21		
Indonesia	64		

A less clear picture emerges with market concentration, namely the percentage of market capitalisation accounted for by the ten largest quoted companies. As Charts 15 and 16 indicate that whereas DEMs did not exhibit any strong trend, the EEMs showed very mixed tendencies of both rising and falling concentration ratios. It is clear however that in the case of the EEMs the markets were far more concentrated in absolute terms than in the DEMs.

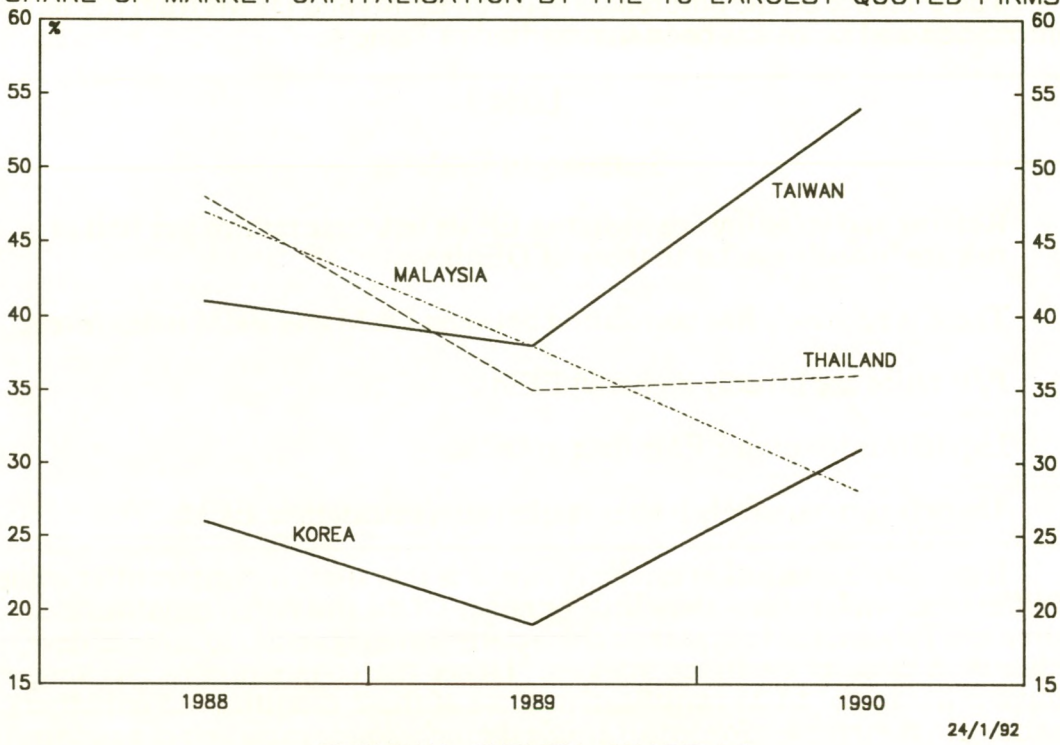
REGIONAL SURVEY: CHART 13
MARKET CONCENTRATION IN EEM:
MARKET CAPITALISATION PER QUOTED COMPANY



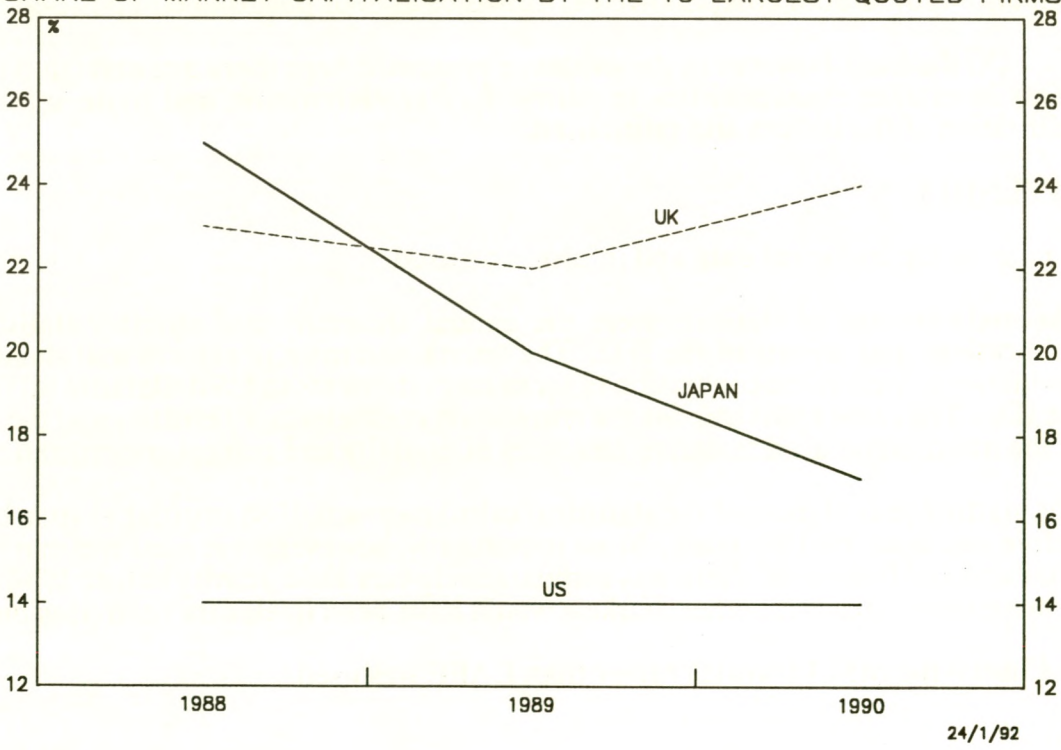
REGIONAL SURVEY: CHART 14
MARKET CONCENTRATION IN DEM:
MARKET CAPITALISATION PER QUOTED COMPANY



REGIONAL SURVEY: CHART 15
MARKET CONCENTRATION IN EEM:
SHARE OF MARKET CAPITALISATION BY THE 10 LARGEST QUOTED FIRMS



REGIONAL SURVEY: CHART 16
MARKET CONCENTRATION IN DEM:
SHARE OF MARKET CAPITALISATION BY THE 10 LARGEST QUOTED FIRMS



SUMMARY AND CONCLUSIONS

The evidence on the differences between EEMs and DEMs from the statistical information and ratios has been summarised in Table 4.

Table 4

Summary of Evidence

1. Returns and volatility are higher in EEMs but their returns per unit of risk are broadly similar to those of DEMs.
2. There is relatively low correlation between DEM and EEM index levels.
3. P/E ratios are broadly higher in EEMs.
4. Liquidity is lower in EEMs than in DEMs.
5. There is comparatively higher market concentration in EEMs.

If any single conclusion can be drawn, it is that some indicators offer evidence of differences whilst others show little or none. Of the five Asian countries examined Korea and Taiwan stand out as their characteristics being nearer to those of developed rather than those of emerging markets. Hence the conundrum of including in or dropping out of the EEM classification some of these countries but not others. As indicated in the introduction to this article the inclusion or exclusion of a country from the EEM classification is more than of just academic or taxonomic interest. For example, the composite indices of IFC includes Korea and Taiwan and hence can influence estimates of comparative performance and/or portfolio composition.

On the basis however of the evidence presented here there are enough differences in market characteristics to permit further elaboration and more sensitive calibration of the indices and ratios used.

APPENDIX

A note on the statistical data and information used.

The main sources of statistics were the annual, quarterly and monthly statistical publications and reports of the IFC. The annualised rates of returns and standard deviations as well as the conversion of these measurements to US dollars are all from the IFC. The same holds true for the correlation coefficients, P/E ratios and the rest of the information used to derive measures of liquidity and market concentration.

The starting year of most of the statistical calculation was 1986 in order to span both before and after the 1987 crash. More importantly, however, in at least two markets, Thailand and Indonesia, there was comparatively very little activity before 1986 and hence comparisons with other markets would have been irrelevant or impossible.

In Chart 8 the MSCI (World) rather than EAFE was used.

JAPAN
HOW LONG CAN THE CURRENT ACCOUNT SURPLUS BE RECYCLED AT PRESENT EXCHANGE RATES?

In recent months Japan's balance of payments has appeared to be strengthening rapidly as imports slow in line with the weakening economy, but exports improve in anticipation of a US economic recovery. In 1991 the current account recorded a surplus of US$ 72.6 billion, and in the first two months of 1992 the current account surplus has been running at an annualised rate of US$ 100 billion. Yet, the Yen has been surprisingly weak given the underlying strength of the balance of payments.

A provisional explanation for the Yen's relative weakness can be found in expected interest rate differentials. Investors are expecting US interest rates to stop falling or even to rise, and the returns on other US assets to rise, prompting a portfolio shift into US dollars. Conversely, investors are expecting Japanese interest rates to fall and the returns on other Japanese assets to fall, prompting shifts out of Yen and into US dollars. The problem with this explanation is that it does not appear to be supported by balance of payments data. For example in 1991 Japan actually experienced a long term capital inflow of US$ 36.6 billion in addition to running a current account surplus of US$ 72.6 billion, giving a so-called basic balance surplus of US$ 109.2 billion.

To understand recent developments in Japan's balance of payments it is worthwhile to review some of the fundamentals of balance of payments accounting. The most basic point is that the balance of payments always balances i.e. for every transfer from a resident to a non-resident (or vice versa) of goods, services, assets or liabilities, there is a corresponding payment of money in the other direction. Thus the purchase by a Japanese resident of foreign bonds is matched by a payment to the non-resident of an equivalent amount of money (Yen or Dollars or other currency). The Japanese acquisition of the foreign bond is recorded as a long term capital outflow and the payment to the non-resident might be recorded as a reduction in the short term foreign liabilities of Japanese banks. Depending on how the accounts of the balance of payments are presented, the same transaction could lead to different arithmetic results, even though there was no material change in the underlying position.

Part of the explanation for the apparently peculiar phenomenon of Japan running a large current account surplus and a long term capital inflow in 1991 results from the particular style of presenting Japan's balance of payments data. We start, therefore, with the basic equation and show how Japan's payments data are normally presented. We then review developments in the 1980s as a preliminary step to explaining recent changes in Japan's balance of payments.

(1) Current Account
+ Capital Account
= Zero.

Dividing the capital flows into long term (assets or liabilities with over one year maturity) and short term (assets or liabilities with under one year maturity) components we get:

(2) Current Account
+ Long Term Capital Flows
+ Short Term Capital Flows
= Zero.

Extracting the actions of the monetary authorities from short term and long term capital flows and moving them to the other side of the equation, segregating the short term capital flows of the banks, and including errors and omissions as a balancing item (because the collected data are not always comprehensive), we get the IMF-style presentation of the balance of payments :

(3) Current Account
+ Private Sector Long Term Capital Flows
+ Short Term Capital Flows of Non-Banks
+ Short Term Capital Flows of Banks
+ Errors and Omissions
= Changes in Monetary Authorities' Foreign Exchange Position

The Japanese authorities adopt a slightly different form of presentation. They shift both the actions of the monetary authorities and the short term capital flows of the banks (the two underlined items above), to the other side of the equation, or in balance of payments jargon, "below the line". Hence the Japanese style presentation of the balance of payments data is as follows :

(4) Current Account
+ Private Long Term Capital Flows
+ Short Term Capital Flows of Non-Banks
+ Errors and Omissions
= "Overall Balance"
= Changes in Monetary Authorities' Foreign Exchange Position
+ Short Term Capital Flows of Banks

This is the format for the data shown in Table 1. Note that the two columns to the right hand side of the overall balance in Table 1 would have their signs reversed if they were shifted back "above the line" or to the left of the overall balance. For the purpose of the discussion which follows Table 2 presents a modified version of the IMF style presentation above in the following format :

(5) Current Account
+ Total Private Sector Capital Flows
(i.e. Long Term Capital
+ Short Term Capital including banks)
+ Actions of Monetary Authorities
+ Errors and Omissions
= Zero.

Table 1

JAPAN'S BALANCE OF PAYMENTS: BANK OF JAPAN STYLE PRESENTATION

(US$ millions)

	Current Account	Long Term Capital	Short Term Capital (excluding banks)	Errors and Omissions	Overall Balance	Change in Foreign Exchange Position of Monetary Authorities	Balance of Monetary Movements (= Short Term Capital of Banks)
81	+ 4,770	- 6,449	- 958	+ 493	- 2,144	+ 3,171	- 5,315
82	+ 6,850	- 14,969	- 1,579	+ 4,727	- 4,971	- 5,141	+ 170
83	+ 20,799	- 17,700	+ 23	+ 2,055	+ 5,177	+ 1,234	+ 3,943
84	+ 35,003	- 49,651	- 4,295	+ 3,743	- 15,200	+ 1,817	- 17,017
85	+ 49,169	- 64,542	- 936	+ 3,991	- 12,318	+ 197	- 12,515
86	+ 85,845	- 131,461	- 1,609	+ 2,458	- 44,767	+ 15,729	- 60,496
87	+ 87,015	- 136,532	+ 23,865	- 3,893	- 29,545	+ 39,240	- 68,785
88	+ 79,631	- 130,930	+ 19,521	+ 2,796	- 28,982	+ 16,183	- 45,165
89	+ 57,157	- 89,246	+ 20,811	- 22,008	- 33,286	- 12,767	- 20,519
90	+ 35,761	- 43,586	+ 21,468	- 20,877	- 7,234	- 7,842	+ 608
91	+ 72,598	+ 36,628	- 26,352	- 6,505	+76,369	- 8,073	+84,442

Table 2

JAPAN'S BALANCE OF PAYMENTS: MODIFIED IMF-STYLE PRESENTATION

(US$ millions)

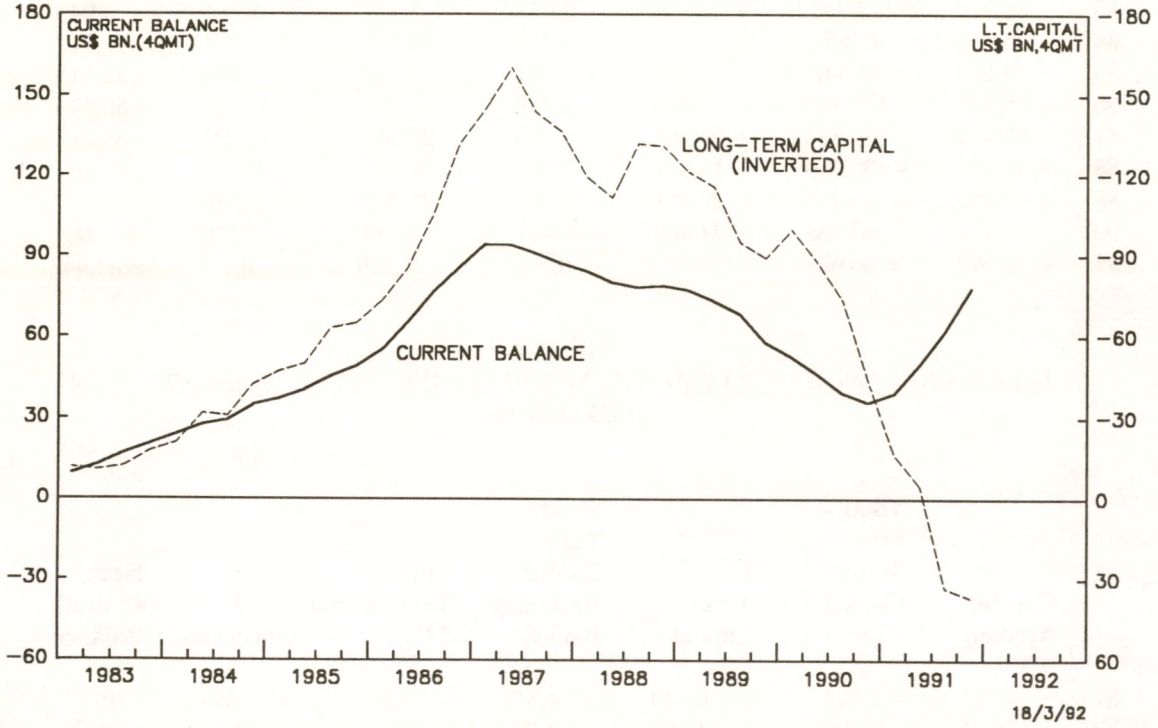
	Current Account	Total Private Sector Capital Flows	Long Term Capital	Short Term Capital (including Banks)*	Official Transactions **	Errors and Omissions	Net Overall Balance
81	+ 4,770	- 2,092	- 6,449	+ 4,357	- 3,171	+ 493	0
82	+ 6,850	- 16,718	- 14,969	- 1,749	+ 5,141	+ 4,727	0
83	+ 20,799	- 21,620	- 17,700	- 3,920	- 1,234	+ 2,055	0
84	+ 35,003	- 36,929	- 49,651	+ 12,722	- 1,817	+ 3,743	0
85	+ 49,169	- 52,963	- 64,542	+ 11,579	- 197	+ 3,991	0
86	+ 85,845	- 72,574	- 131,461	+ 58,887	- 15,729	+ 2,458	0
87	+ 87,015	- 43,882	- 136,532	+ 92,650	- 39,240	- 3,893	0
88	+ 79,631	- 66,244	- 130,930	+ 64,686	- 16,183	+ 2,796	0
89	+ 57,157	- 47,916	- 89,246	+ 41,330	+12,767	- 22,008	0
90	+ 35,761	- 22,726	- 43,586	+ 20,860	+ 7,842	- 20,877	0
91	+ 72,598	- 74,166	+ 36,628	- 110,794	+ 8,073	- 6,505	0

* Since the capital flows of banks have been brought "above the line" in this table, their sign is reversed.

** Similarly, the signs in this column have been reversed from Table 1. A plus sign implies a net capital inflow or reduction in foreign exchange reserves, while a minus sign implies a net capital outflow or an increase in foreign exchange reserves.

During the 1980s the essential developments on Japan's balance of payments were the build-up of large current account surpluses, roughly matched by substantial capital outflows. In the period 1984-89 long term capital outflows significantly exceeded the current account surpluses (see Chart 1). Through this period Japanese banks and other financial institutions were investing in long term assets abroad (such as US Treasury bonds or mortgage backed securities or other high yielding papers), financing these investments either directly or by adding to their short term foreign borrowings. Under Japan's balance of payments reporting convention the long term investments were recorded as long term capital outflows, but the financing of them by the banks' short term borrowings was recorded "below the line" as part of the "balance of monetary movements" (see Table 1).

JAPAN: CHART 1
CURRENT ACCOUNT AND LONG-TERM CAPITAL



The net result is shown in Table 2 which combines the long and short term capital flows of both the non-banks and the banks to give a figure for total private sector capital flows. If the authorities did not want the Yen to appreciate, then whenever the current account surplus exceeded the total private sector capital outflow (e.g. as in 1986-88) the monetary authorities had to step in to buy the surplus foreign exchange in order to hold the Yen at the then current exchange rate. Conversely, if the combination of total private sector capital flows and other unrecorded transactions (the balancing item shown as errors and omissions) exceeded the current acount surplus (e.g. as in the period 1989-91) and the authorities did not want the Yen to depreciate, then the Bank of Japan had to step into the foreign exchange market and buy Yen, selling foreign currency. In Table 2 this is recorded as an "inflow" due to official transactions and it is matched by a reduction in official foreign exchange

reserves. Thus whereas between 1986 and 1988 the Yen was regularly under upward pressure, between 1989 and 1991 the Yen was on the whole under some downward pressure with the Bank of Japan supporting it in the foreign exchange market.

It is apparent from Table 1 that the build-up of net short term foreign liabilities by the banks played a major role in facilitating the acquisition of long term foreign assets by the Japanese private sector as a whole. Adding the figures in the right hand column of Table 1 between 1984 and 1989 shows the Japanese banks accumulated a total of US$ 224.5 billion in net short term foreign liabilities. Since Japanese banks are very restricted in terms of the net open positions they can take in foreign exchange markets but they are not restricted in terms of the permitted maturity mismatch of their assets and liabilities, we can presume that the US$ 224.5 billion increase in foreign liabilities was roughly matched by the acquisition of a similar quantity of foreign assets either by the banks or their (Japanese) customers. In essence Japanese banks were taking advantage of their relatively strong capital position in these years (especially their access to cheap Yen capital) to ride the yield curve abroad. They borrowed short term on the world's capital markets and lent long. As long as their Japanese customers were in an expansionary mode and the yield curves in the particular currencies permitted this type of intermediation, the Japanese banks were able to expand their overseas activity vigorously.

However, as the data in Table 1 shows, this activity came to an abrupt halt in 1990, which was also the year in which Governor Mieno's monetary squeeze at home started to impact the banks notably from about June 1990 onwards. From the data it would seem that Japanese banks have been running down their short term foreign liabilities (a reduction in foreign liabilities is shown with a positive sign in Table 1) since 1990, and since Japan's long term capital outflows have also fallen sharply -- reverting indeed to a net inflow in 1991 -- the banks can also be presumed to have been reducing their long term foreign assets correspondingly. (Part of the net capital inflow in 1991 was due to foreigners acquiring Japanese assets, especially equities, in the third quarter of 1991 after having maintained an underweight exposure to Japan for a long period).

Once the Japanese banks have repaid their cumulative short term foreign borrowings, how long can Japan continue to offset its growing current account surpluses with capital outflows? More simply, how long can the total private sector capital outflow be relied on to recycle the surplus on the current account without requiring an upward adjustment in the value of the Yen?

As shown in Table 1, the balance of monetary movements jumped from US$ 0.6 billion in 1990 to US$ 84.4 billion in 1991, which is to say the net short term foreign asset position of Japanese banks improved or their net short term foreign liability position was reduced. Underlying data (not shown in the table) make it clear that it was the latter, not the former. In other words, out of the US$ 224.5 billion in cumulative net short term borrowing by Japanese banks between 1984 and 1989, only some US$ 139.5 billion remained at the end of 1991. In January and February 1992 there was a further rundown of US$ 24.3 billion, leaving only US$ 115.2 billion outstanding. Since it is unlikely that Japanese banks will completely withdraw from their activity in overseas markets, their net short term borrowing position will almost certainly not decline to zero. However, as long as the domestic monetary squeeze

continues inside Japan, Japanese financial institutions may remain under pressure to liquidate foreign assets and reduce foreign borrowings correspondingly. This process of balance sheet reduction will also help them to meet the BIS capital ratios more easily.

Looking ahead there are two ways in which the emerging disequilibrium between Japan's rapidly growing current account surplus and its declining long term capital outflows can be resolved. One possibility is that the gap can be made up by a substantial further run-down of the cumulated net short term foreign borrowing by the Japanese banks, matched by a sale of long term assets by Japanese banks or their clients. In balance of payments terms the repayment of net short term borrowings is equivalent to an increase in assets and hence makes up for the capital outflow. This implies Japanese banks withdrawing from the aggressive intermediation they had conducted in world capital markets during the mid-1980s, and will be the international consequence of the meltdown of land and stock price values in the domestic economy. However, there are distinct limits to this process -- limits set by the net outstanding short term foreign borrowings of Japanese banks.

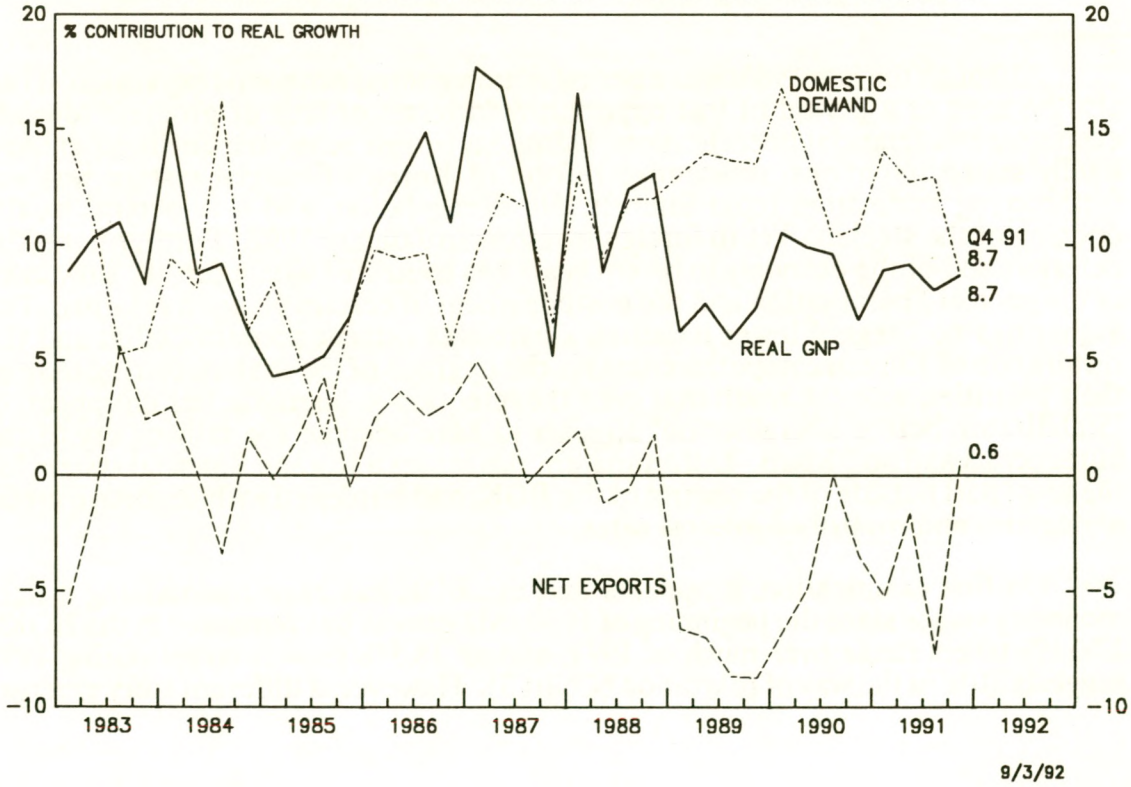
The other possibility is that the current account surplus simply overwhelms the capital outflows at current levels of the Yen-Dollar exchange rate and forces a large upward appreciation in the value of the Yen. As Japan is already facing an internally induced recession due to excessively tight money, the Japanese authorities will be very reluctant to add to the downturn in economic activity by allowing the Yen to rise sharply. It therefore seems unavoidable, at some point in the not too distant future, that the Japanese authorities will lower interest rates again (and probably more than once) to counteract either the domestic recession and/or an appreciating currency.

SUMMARY AND FORECAST: In the mid-1980s short term borrowing by Japanese banks played an important part in financing long term capital outflows, which in turn offset the substantial current account surpluses. Recently the current account surplus has been running at an annual rate of about US$ 100 billion, which will either require huge capital outflows to offset, or could lead to a big appreciation in the Yen. However, because of the changed position of the Japanese banks and their customers following the domestic financial squeeze and collapse of the asset bubble, Japanese banks are no longer able to add to their short term foreign borrowings to finance long term capital outflows to match the current account surplus. Therefore in view of the likelihood of Japanese interest rates falling and Japanese banks being able, at least for a while, to repay net short term borrowings abroad (which is equivalent to a capital outflow in balance of payments terms), the Yen should stay weak for a few months. However, once the Japanese banks cease to be able to recycle the current account surpluses by repaying foreign borrowings, the Yen should move into a period of fundamental strength.

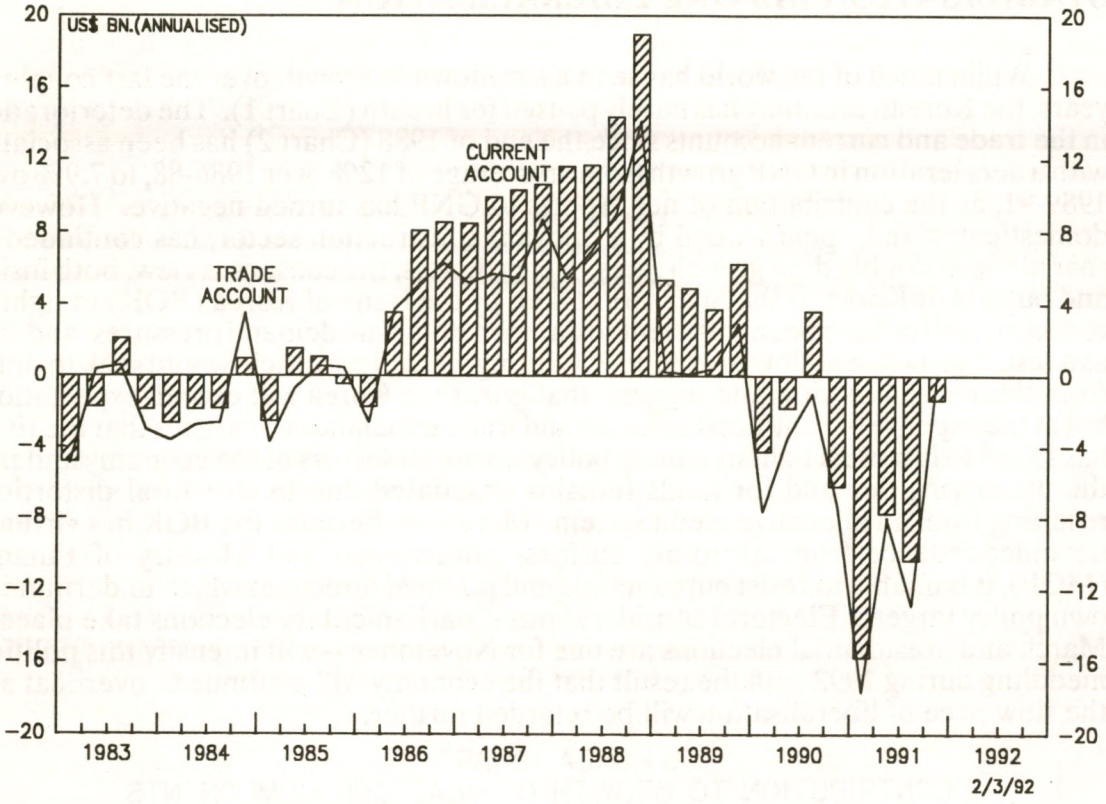
SOUTH KOREA
STABILISATION BEFORE LIBERALISATION

While much of the world has seen a slowdown in growth over the last couple of years, the Korean economy has barely paused for breath (Chart 1). The deterioration in the trade and current accounts since the end of 1988 (Chart 2) has been associated with a deceleration in GNP growth from an average of 12% over 1986-88, to 7.9% over 1989-91, as the contribution of net exports to GNP has turned negative. However, domestic demand, spearheaded by a buoyant construction sector, has continued to roar along at double digit growth rates. Nevertheless, the consensus view, both inside and outside of Korea, is that measures taken by the Bank of Korea (BOK) to tighten monetary policy have been sufficient to dampen domestic demand pressures, and that as a result, growth will slow to around 7% during 1992. This article would seek to differ from this consensus view and suggests that growth in Korea will exceed expectations but at the expense of continued inflation and trade imbalances. It argues that the BOK has failed to impose a tight monetary policy across all sectors of the economy and that the underlying demand for funds remains unsatiated due to structural distortions resulting from an allocative credit system. Moreover, because the BOK has virtually no independence from a pro-big business government and Ministry of Finance (MOF), it is unable to resist bureaucratic and political directives which undermine its own policy targets. Electoral considerations -- parliamentary elections take place in March and presidential elections are due for November -- will intensify this political meddling during 1992 with the result that the economy will continue to overheat and the slow pace of liberalisation will be retarded further.

S.KOREA: CHART 1
CONTRIBUTION TO GROWTH OF REAL GNP COMPONENTS



S.KOREA: CHART 2
TRADE AND CURRENT ACCOUNTS



Although the late 1980s was a period of tremendous economic expansion, it can also be seen as a period of lost opportunity in terms of lack of progress towards economic and financial liberalisation. Despite a benign economic environment and loudly stated intentions, substantive reform of Korea's financial system was not forthcoming aside from tepid interest rate deregulation, and a reluctant, partial opening of the stockmarket to foreign investors in January 1992. Furthermore, the deterioration of the economy in recent years has coincided with a further slowdown in the pace of liberalisation and the postponement of certain planned reforms. The authorities now regard lower inflation, a narrower current account deficit and the restoration of Korean competitiveness via the upgrade of the manufacturing base as their priorities, with the result that even the intention to liberalise has disappeared. "Stabilisaton before liberalisation" appears to have become the rallying cry of the bureaucrats and politicians. Unfortunately, this leaves a Korean financial system for the most part outside of the control of the BOK, and burdened with distortive credit allocations and controlled interest rates.

On first examination, it appears that the BOK has been maintaining a tight monetary stance since the beginning of 1990. M2 growth has remained in the BOK's 17-19% target range over much of 1991, and an 18.5% growth target during 1992 suggests little in the way of relaxation (Chart 3). However, a different story emerges

when one looks at alternative measures of money. The BOK continues to target M2 -- broadly currency plus demand, time and savings deposits at monetary institutions -- because it remains the only aggregate over which it has reasonably full control. An 11.5% reserve requirement is imposed on all types of deposits and from time to time, a marginal reserve requirement is imposed on incremental deposits accrued. Unfortunately for the BOK, the level of M2 is only a third of the level of M3 -- M2 plus deposits of other financial institutions (OFI), debentures issued, commercial bills sold, certificates of deposit and bond repurchases -- and under 60% of the level of OFI deposits. The BOK would like to be able to impose reserve requirements on the OFI deposits as well, but to date the MOF has resisted in order to prevent a dilution of power. In fact the MOF does impose minimum reserve requirements on OFI deposits, but these can be held as interest bearing deposits at commercial banks, as opposed to non-interest bearing deposits at the BOK. Given the pro-growth bias of the MOF, it is hardly surprising that the non-bank monetary squeeze has been less severe as evidenced by continued M3 growth of around 25%.

The BOK has watched its power to control the monetary aggregates -- in 1980, M2 was 70% of M3 -- diminish in recent years as the non-bank sector has expanded rapidly. It has not been slow to recognise the problem but has been unable to redress it. An indicator that the BOK is unhappy with the lack of monetary control afforded by targeting M2, is its development of a new target, M2B, although it is no more able to fully control this aggregate than it is able to control M3. M2B comprises M2 minus long term (greater than 3 years) time and savings deposits at monetary institutions plus short term OFI deposits. Neither M2B nor a breakdown by maturity of OFI deposits is published by the BOK, but an estimate can be made if one assumes that OFI hold a similar proportion to monetary institutions of short to long term deposits. It is therefore assumed that 80% of OFI deposits are of a short term nature, although if anything, OFI will probably hold a greater proportion of short term liabilities and thus the estimate of M2B could be understated. Chart 4 shows a plot of M2B growth against M2. It is likely that the November 1991 figure is an outlier reflecting the year-on-year effect of the spike upward in November 1990. Ignore this outlier, and M2B can be seen to be still growing around 25%. Allowing for 8% real GNP growth and a long term historical downward trend of 2% in M2 velocity (Chart 5), and it is difficult to see how the recent downward trend in inflation (Chart 6) can be sustained.

The BOK appears to share this view but sadly its view does not seem to prevail at the current time. The behaviour of interest rates offers the best clue as to who is really pulling the strings. Chart 7 plots a number of different Korean interest rates and clearly shows that a fair proportion of these rates are anything but market determined. A summary of Korean interest rate deregulation is contained in the box on page 24. The corporate bond and MSB yields, the two interest rates that are supposedly most free, indicate that monetary policy was being progressively tightened from early 1990 all the way through to the end of 1991. This succeeded in moderating money growth, but as outlined above, despite a relative slowdown, absolute growth rates remain too high. The 2-300 basis point fall in yields since the beginning of the year is therefore unjustified, at least in a monetary sense. However, from a political and business standpoint, the fall in rates is extremely timely.

It appears that rates have fallen due to a combination of government pressure and chaebol-inspired Ministry of Trade and Industry lobbying. First, the government faces both parliamentary and presidential elections during 1992 and is therefore keen to avoid a sharp slowdown in the economy. Second, Korea's large industrial conglomerates or chaebols have been demanding a lower cost of funds to compensate for the drop in world demand for their exports.

Interest Rate Deregulation in Korea

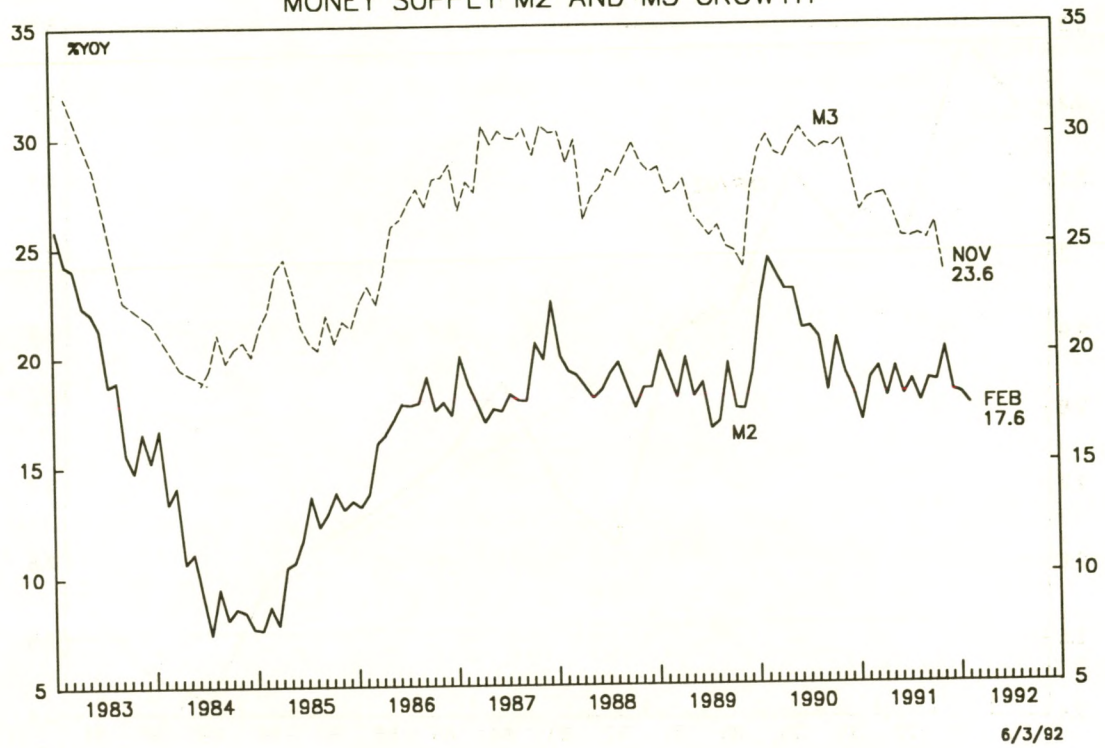
Liberalisation to date

1980-82	Most preferential interest rates on policy loans are abolished.
1984	Deposit money banks are permitted to determine their own lending rates, according to credit-worthiness, within a given range.
	The upper limit on call rates is lifted.
1985	Yields on convertible bonds and debentures with bank payment guarantees are decontrolled.
1986	Interest rates on CDs and issuing rates for debentures with bank payment guarantees and financial debentures issued by deposit money banks, are decontrolled.
1988	Bank lending rates are decontrolled.

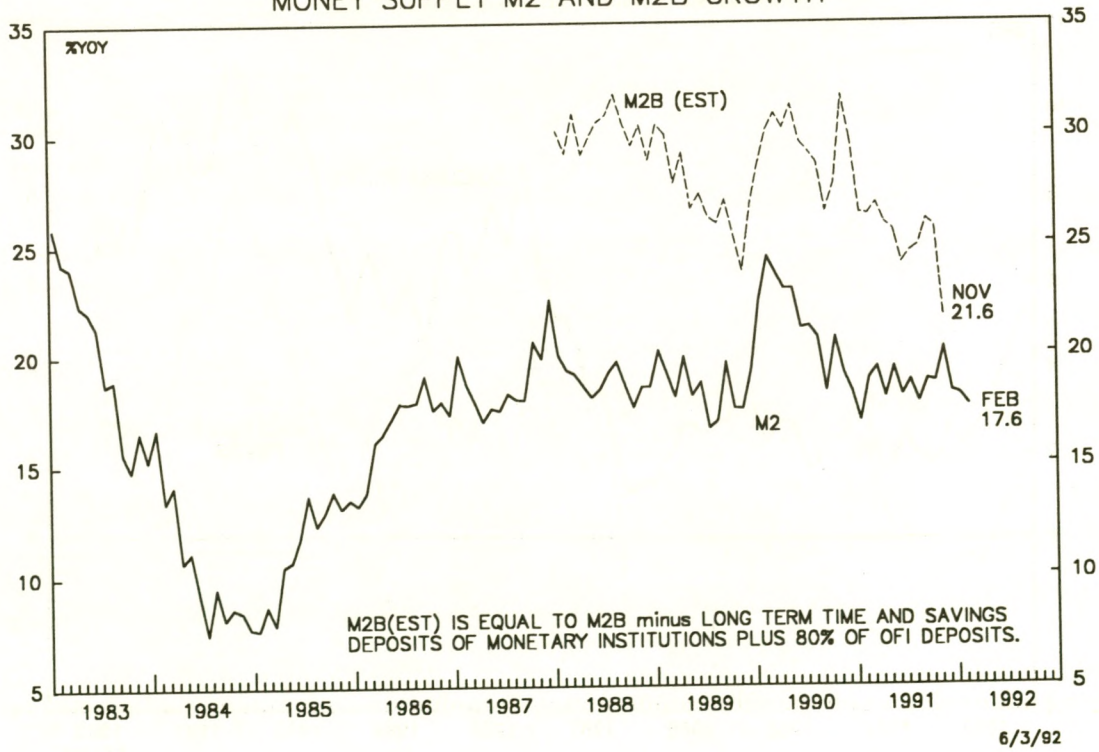
The August 1991 Interest Rate Liberalisation Plan

Aug 91-Jul 92	Deregulation of interest rates on most money market instruments including bankers' acceptances, large denomination commercial paper and banks' CDs, and securities companies' repurchase agreements.
Jul 92-Dec 93	Deregulation of all banks' and non-bank financial institutions' lending rates, and certain long term deposit rates.
1994-96	Interest rates on policy loans and other special credit facilities will be decontrolled.
1997 and after	All remaining restrictions on deposit rates and coupon rates on public bonds will be lifted.

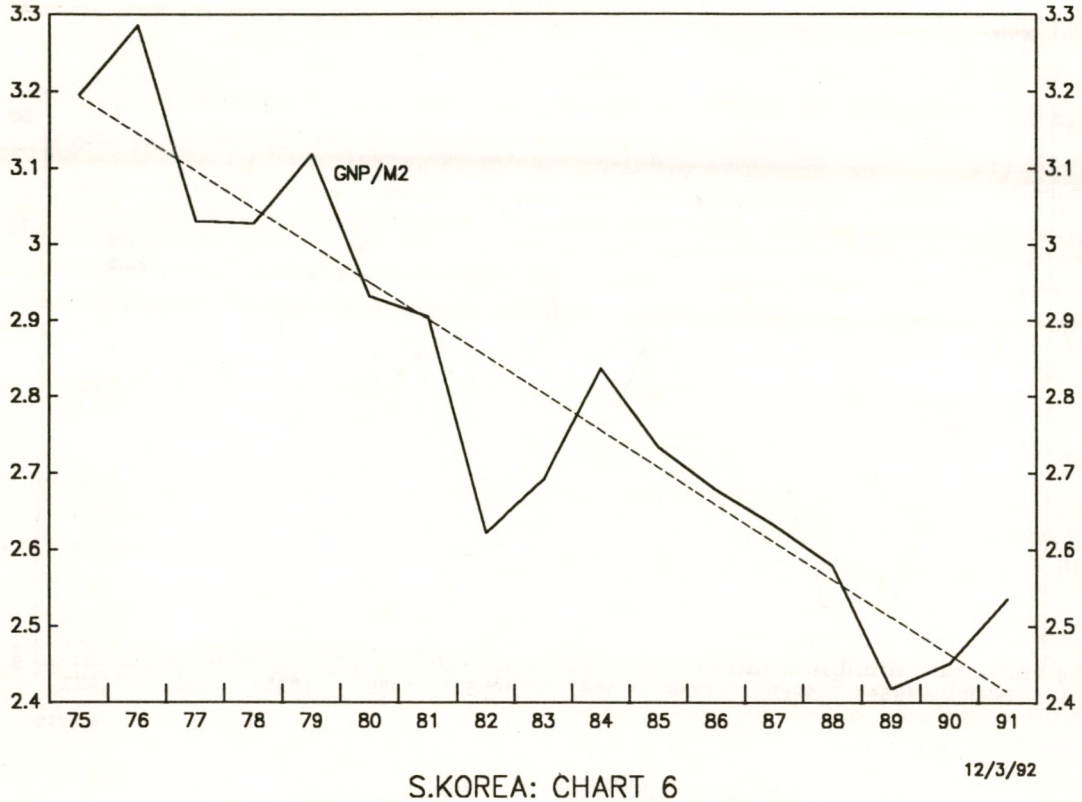
S.KOREA: CHART 3
MONEY SUPPLY M2 AND M3 GROWTH



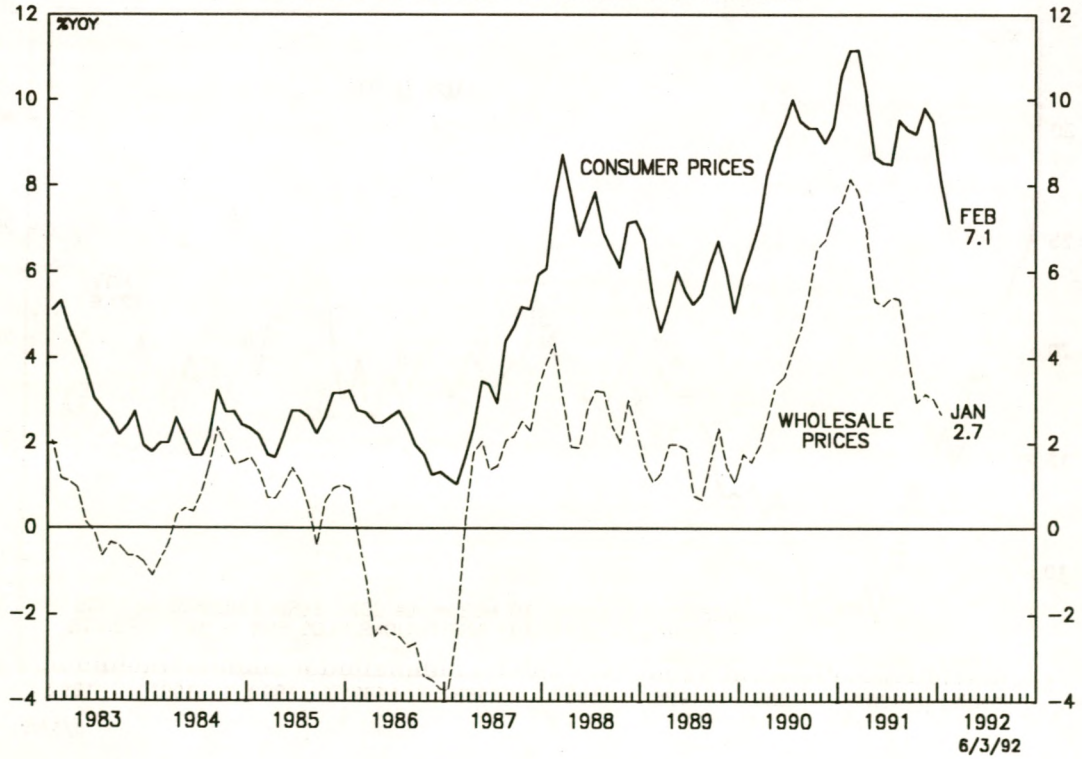
S.KOREA: CHART 4
MONEY SUPPLY M2 AND M2B GROWTH



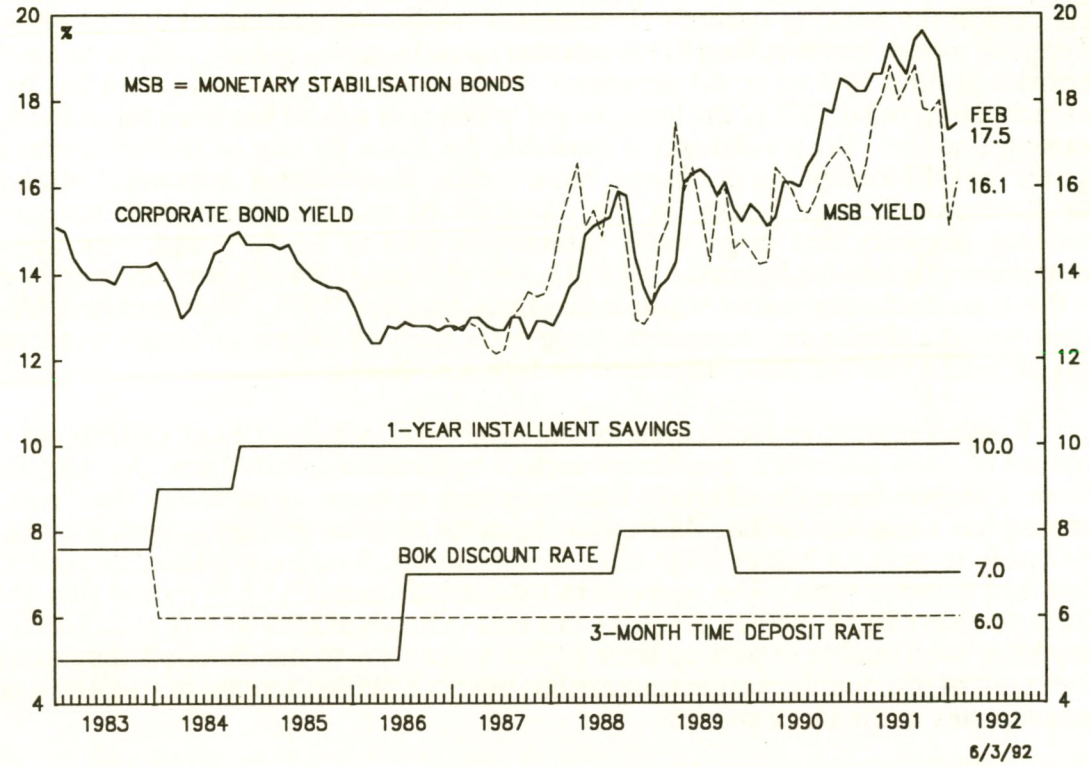
S.KOREA: CHART 5
M2 VELOCITY



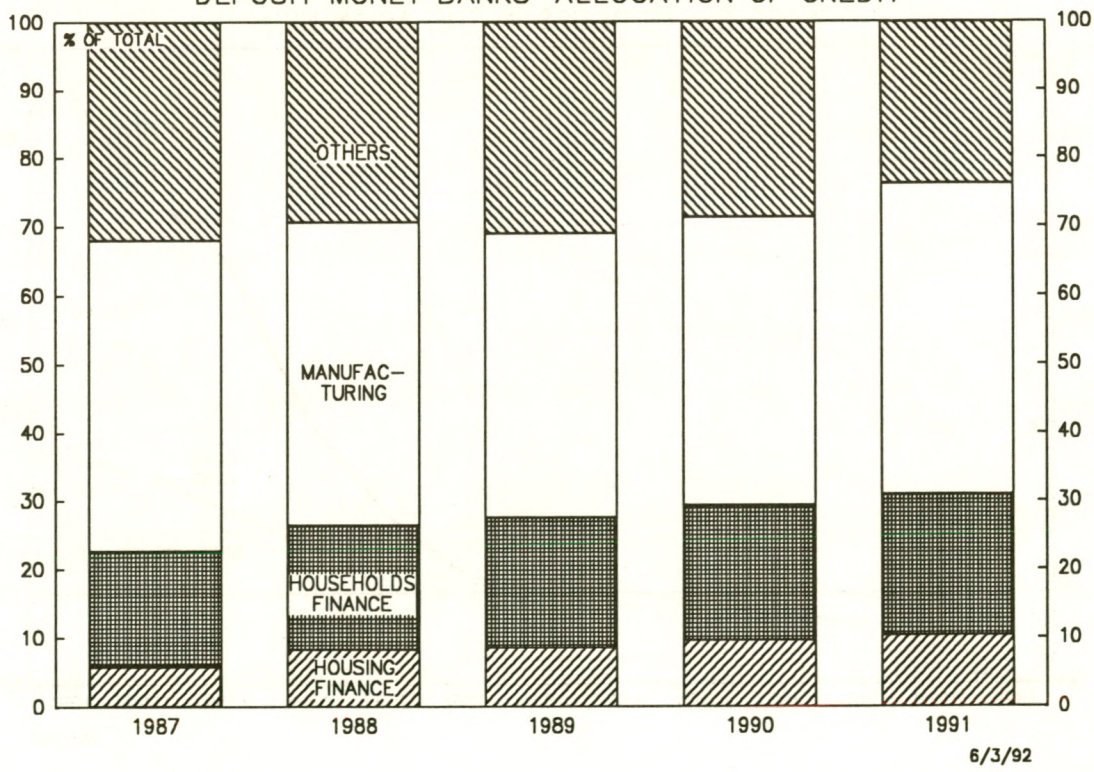
S.KOREA: CHART 6
CONSUMER AND WHOLESALE PRICES



S.KOREA: CHART 7
INTEREST RATES



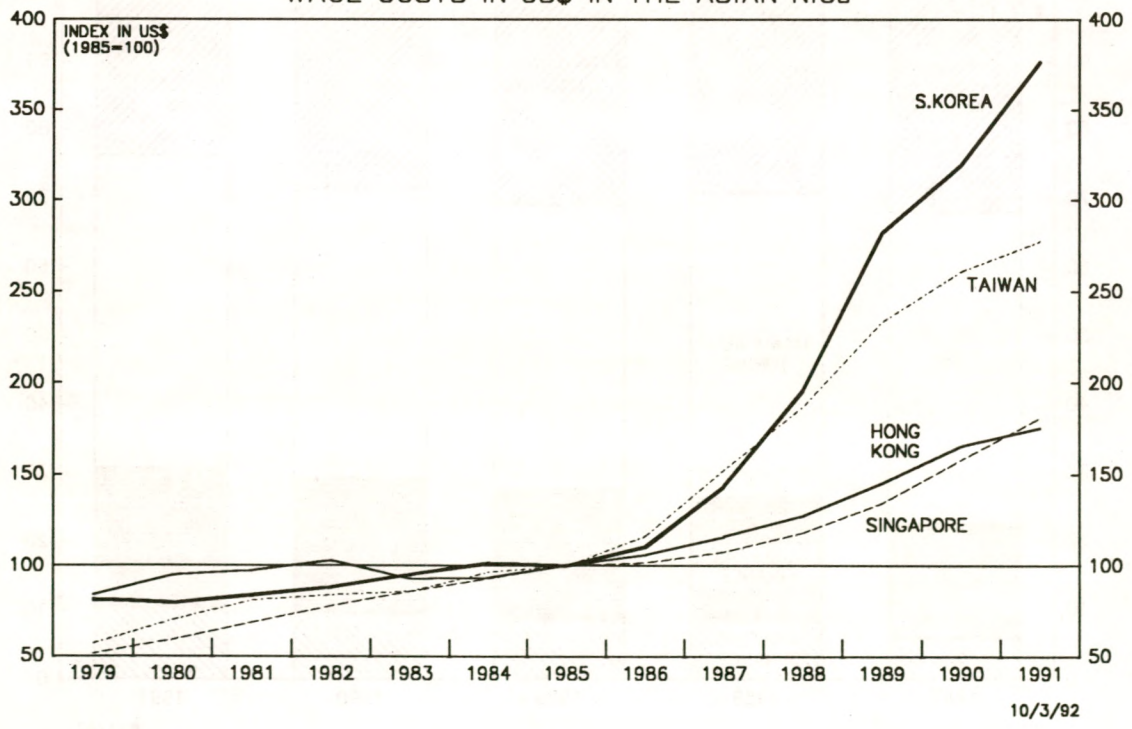
S.KOREA: CHART 8
DEPOSIT MONEY BANKS' ALLOCATION OF CREDIT



In reality, however, the chaebols have escaped the monetary squeeze relatively lightly. This is due to their exalted position in the economic hierarchy which is clearly reflected in the banking system's allocation of credit. An analysis of the loan books of deposit money banks (Chart 8) reveals that manufacturing industry has consistently received around 50% of credit advanced. Meanwhile, the personal sector has been restricted to around 30% of the loan pool of which only a third has been for individual housing finance. No breakdown is available for loans by size of industry, nor are figures for OFI loan books published, but it is clear that credit is channeled, often via the state-owned large banks, in the direction of manufacturers, and anecdotal evidence suggests that large scale enterprises tend to be favoured. By way of comparison, figures for Japan during 1991 show that only 15% of loans advanced were to the manufacturing sector while individuals received 17%. Furthermore, when Japan was at a similar developmental stage in the early 1970s, manufacturers received only around a third of loans advanced by Japanese banks.

Korea's allocative credit system is administered via a series of ceilings on the amount of loans advanced to different sectors by financial institutions. As suggested above, chaebols have found credit relatively easy to come by although their cost of funding has risen somewhat. Moreover, because of their market power, they have been able to pass on higher wage costs to consumers. Small companies by contrast, have had a torrid time. The squeeze in total credit available has meant that their allocation has shrunk further, resulting in a cost of funds of 25% or more. In addition, they have been unable to pass on their higher wage costs to the chaebols they supply. The result of this double margin squeeze has been a 2-300% increase in small business bankruptcies in the last 6 months.

S.KOREA: CHART 9
WAGE COSTS IN US$ IN THE ASIAN NICs



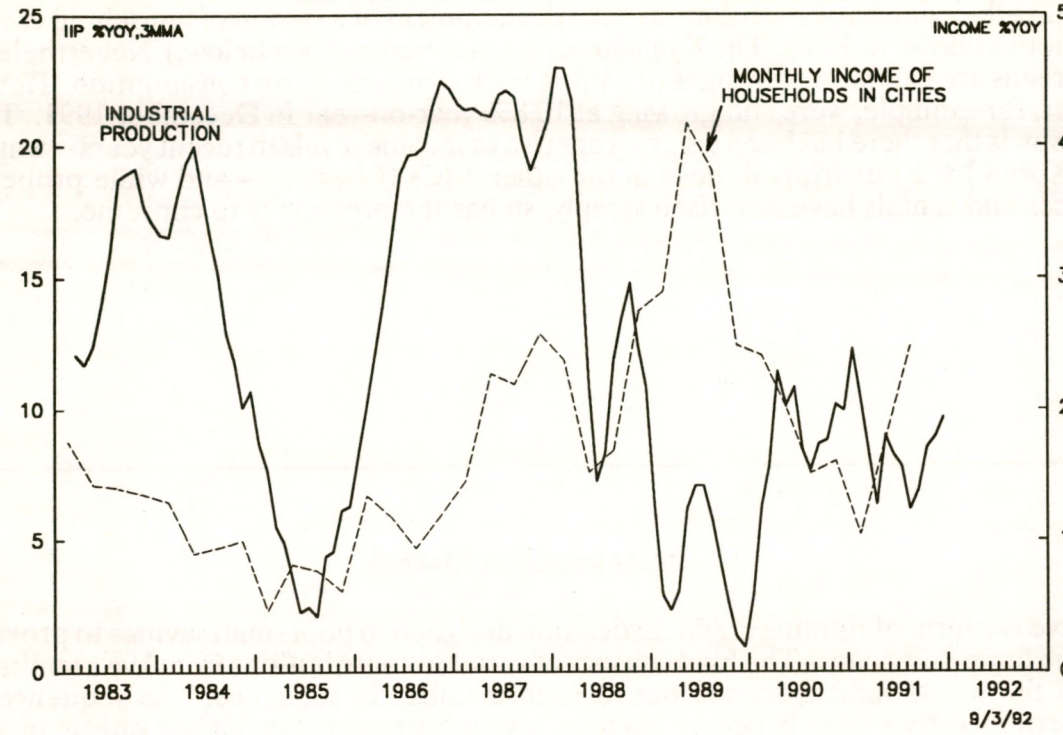
The supply of consumer credit has also been curtailed yet demand remains voracious and unofficial kerb market rates have rise beyond 30%. (The distortions of credit allocation have contributed to the development of a system of household credit societies known as Kyes. The Kye market is described in a box below.) Nevertheless, Koreans are exhibiting few signs of cutting back significantly on consumption. Retail sales, for example, were still growing at 10.8% year-on-year in December 1991. The reason is that there has been a significant rise in income levels in recent years -- wages in Korea have outstripped those in the other NICs (Chart 9) -- and while property prices and rentals have also risen steeply, so has the propensity to consume.

The Korean Kye Market

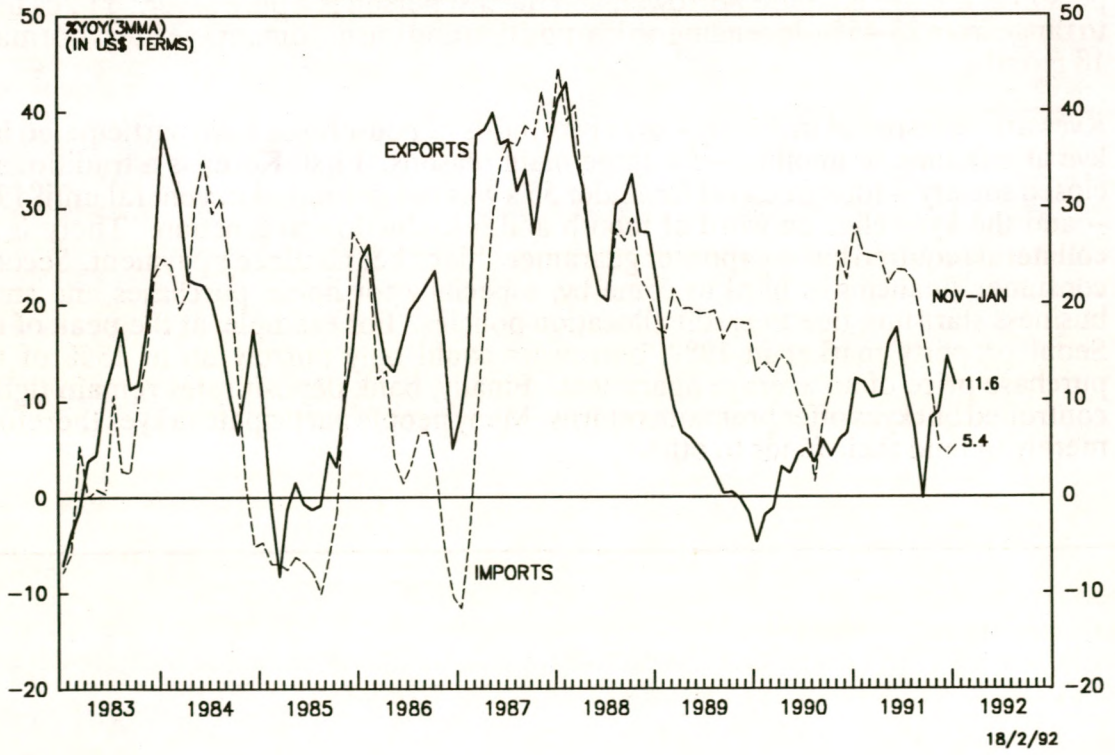
A kye is a form of rotating credit association designed to pool small savings to provide large lump-sum loans. The fund consists of variable contributions from kye members, and the whole fund is loaned out to each member in sequence. The sequence is determined by either ballot or auction. As a borrower, the higher one is in the sequence, the higher is the rate of interest to be paid. As a depositor, the lower one is in the sequence, the higher is the rate of interest received. It follows that the first person in the kye is a pure borrower, and the last person is a pure saver. Yields tend to range from 25-45% depending on kye position and the maximum kye life is normally 18 months.

Kyes are widespread in Korea -- over two-thirds of households have participated in a kye at one time or another -- for three main reasons. First, Korea is a traditionally closed society -- foreign travel for under 55's was not permitted in general until 1989 -- and the kye relies on word of mouth and introduction to function. There is no collateral required but the sponsor guarantees his or her nominee's payment. Second, consumer financing is hard to come by, especially for house purchases and small business start-ups, due to credit allocation policies. For example, at the peak of the Seoul property market in 1989, borrowers could only borrow up to 15% of the purchase price of an average apartment. Finally, bank deposit rates remain tightly controlled but kyes offer premium returns. Many people participate in kyes therefore, merely to lend their funds to others.

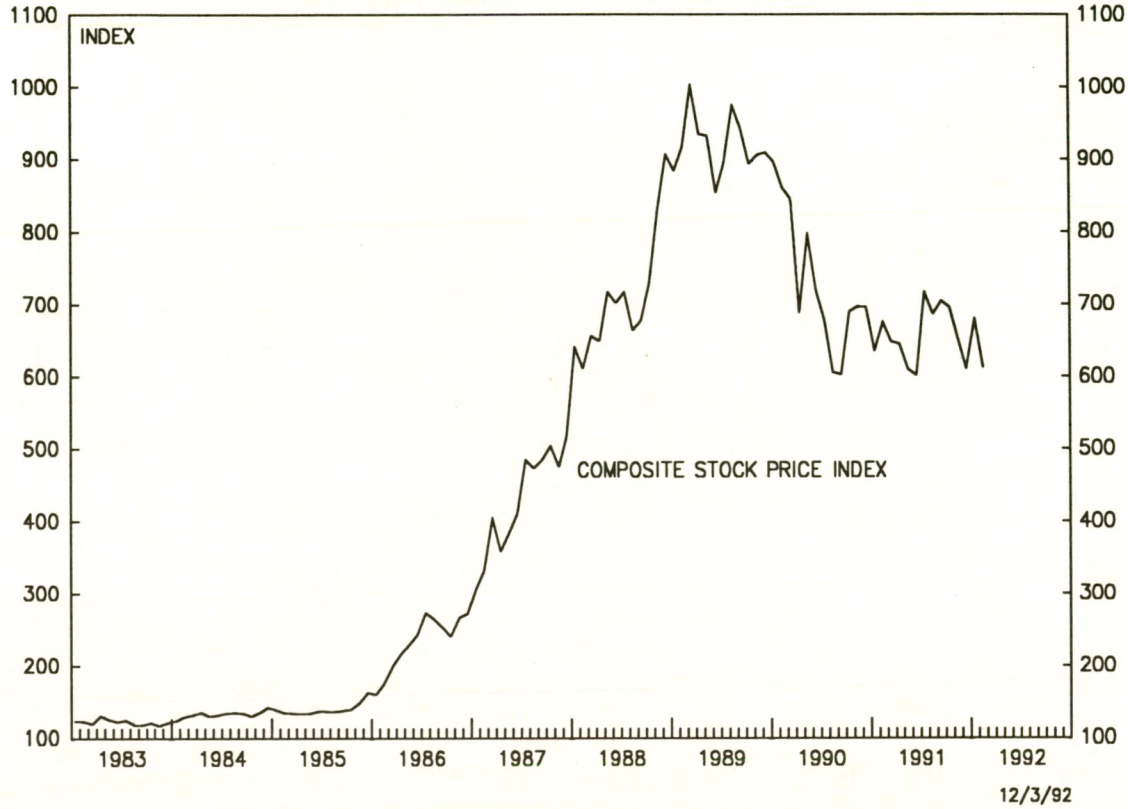
S.KOREA: CHART 10
INDUSTRIAL PRODUCTION AND WAGES



S.KOREA: CHART 11
EXPORTS AND IMPORTS GROWTH

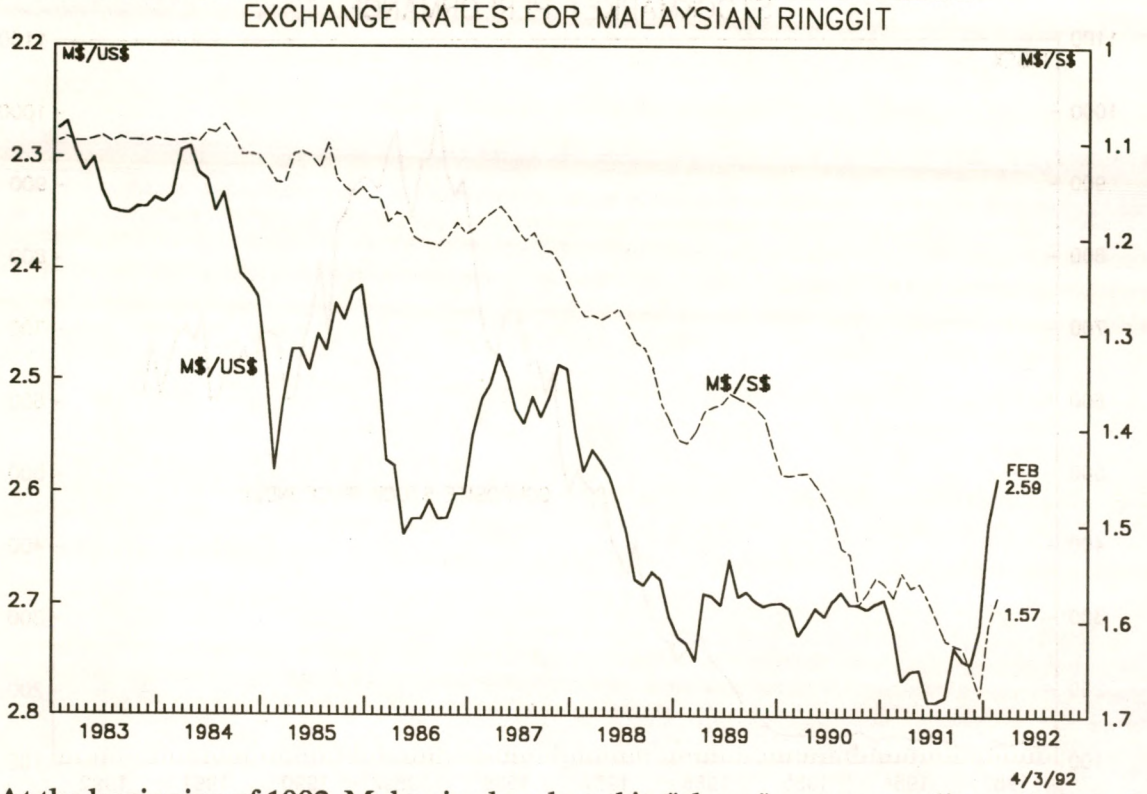


S.KOREA: CHART 12
STOCKMARKET PERFORMANCE



SUMMARY AND FORECAST: The continued distortions of Korea's allocative credit system imply that liquidity is going to remain extremely tight for small businesses and consumers, and relatively easy in the government's targeted sectors. Although interest rates have fallen sharply this year, excessive broad money growth suggests that the trend should still be upward. However, in an election year rates are likely to be held down artificially, irrespective of whether the next round of interest rate deregulation planned for July, proceeds or not. This points towards continued overheating during 1992 with inflation rising back to around 10% and the current account deficit showing scant improvement. Nevertheless, there are a number of signs that suggest cautious optimism for 1993. First, anecdotal evidence suggests that industrial production growth is once again outstrippping the rise in wages and incomes (Chart 10), although data to support this proposition is not yet available. Second, imports have slowed -- although they could pick up again sharply in response to lower interest rates -- and exports have rebounded strongly despite continued weakness in the US (Chart 11). Finally, the opening of the Korean stockmarket to foreign investors suggests that once stabilisation is achieved, liberalisation could accelerate. In view of easier liquidity in certain sectors and continued strong domestic demand, the stockmarket, which has languished in the doldrums since the end of 1989 (Chart 12) could perform reasonably this year. However, once the elections are over, a retightening of monetary policy is likely to affect the market adversely. In the interim, the Korean authorities will rely on controls, directives and moral suasion, rather than monetary rectitude, to keep the lid on a strongly simmering economy.

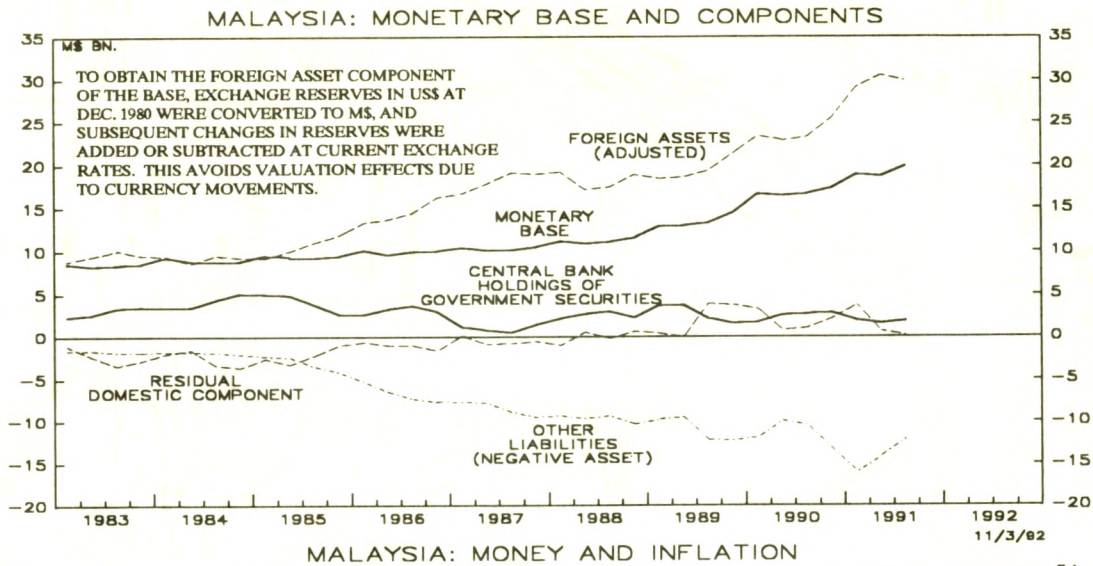
MALAYSIA: A REVERSAL IN EXCHANGE RATE POLICY

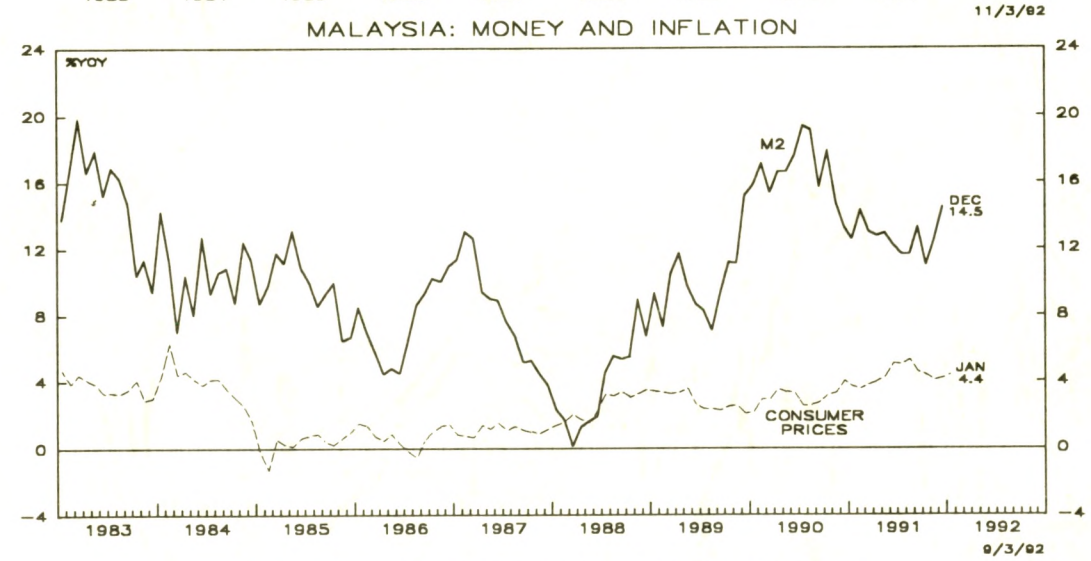


At the beginning of 1992, Malaysia abandoned its "cheap" currency policy and started to engineer a revaluation of the Ringgit against its major competitor currencies -- the US dollar and the Singapore dollar. Since January 1st, the Ringgit has appreciated around 6% against both currencies and is now at its highest level against the US dollar since 1988. This reversal of policy is long overdue -- a "fair" value estimate for the Ringgit is around M$2.40 = US$1 -- and should help Bank Negara (BN) in its efforts to cool a still overheated economy. It frees BN from its dilemma of having to suppress the currency while raising interest rates, and will give the central bank more scope in its conduct of monetary policy.

AMM Vol. 15 No. 6 outlines how in late 1990 and early 1991, BN restricted the growth of the monetary base by borrowing heavily in the interbank markets. BN has been able subsequently to reverse some of these borrowings without expanding money supply, due to the drying up of inward foreign direct investment which has curtailed the growth of foreign assets. Imports have also slowed sharply in line with long term capital inflows.

Were the authorities to maintain their strong currency policy and allow the Ringgit to appreciate further, this would eventually be reflected in a narrower current account deficit and a sustainable fall in inflation. (Despite a recent dip, the trend is still upward.) However, as the current inflow of speculative short term capital accelerates, so the currency will continue to rise until BN feels compelled to cap its appreciation. Currently these inflows are reflected in portfolio shifts within the banking system but when BN starts to intervene the result will be lower interest rates and faster money growth. The question remains as to how far BN will allow the currency to go before it steps into the market.


MALAYSIA: MONETARY BASE AND COMPONENTS
M$ BN.
TO OBTAIN THE FOREIGN ASSET COMPONENT OF THE BASE, EXCHANGE RESERVES IN US$ AT DEC. 1980 WERE CONVERTED TO M$, AND SUBSEQUENT CHANGES IN RESERVES WERE ADDED OR SUBTRACTED AT CURRENT EXCHANGE RATES. THIS AVOIDS VALUATION EFFECTS DUE TO CURRENCY MOVEMENTS.
FOREIGN ASSETS (ADJUSTED)
MONETARY BASE
CENTRAL BANK HOLDINGS OF GOVERNMENT SECURITIES
RESIDUAL DOMESTIC COMPONENT
OTHER LIABILITIES (NEGATIVE ASSET)
35 30 25 20 15 10 5 0 -5 -10 -15 -20
1983 1984 1985 1986 1987 1988 1989 1990 1991 1992
11/3/92


MALAYSIA: MONEY AND INFLATION
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M2
DEC 14.5
JAN 4.4
CONSUMER PRICES
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1983 1984 1985 1986 1987 1988 1989 1990 1991 1992
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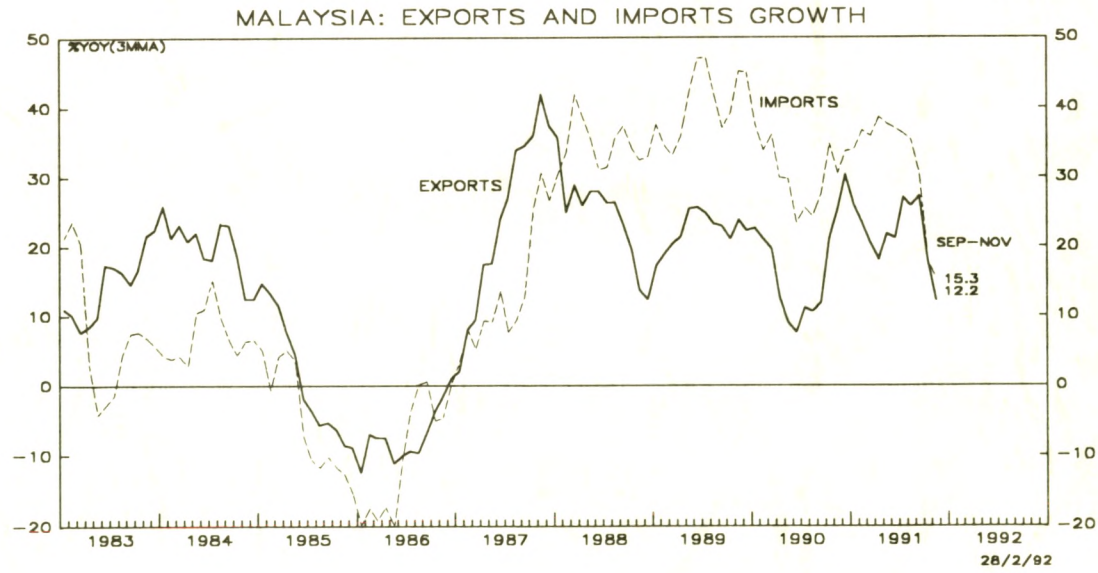
MALAYSIA: EXPORTS AND IMPORTS GROWTH
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IMPORTS
EXPORTS
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50 40 30 20 10 0 -10 -20
1983 1984 1985 1986 1987 1988 1989 1990 1991 1992
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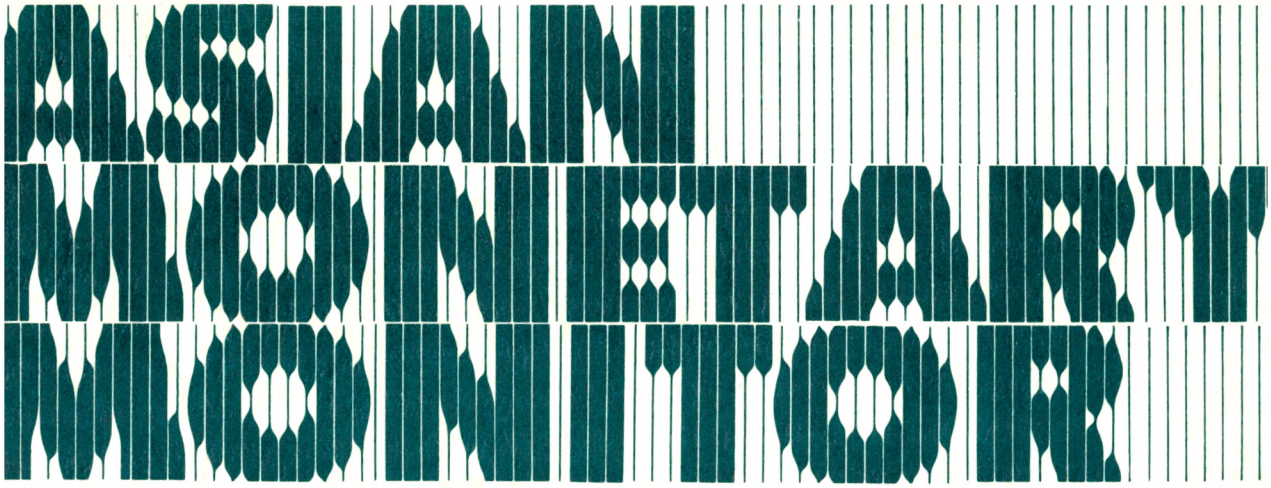
AMM May-June 1992 Vol. 16 No.3



CONTENTS

		Page
REGIONAL SURVEY		
The Collapse of Subcontinent Socialism by Simon Ogus		1
HONG KONG		
Reappraising the Importance of China in the Economy by Andrew Freris		15
NEW ZEALAND		
Recovery At Last by John Greenwood		26
ECONOMIC CAPSULES		
Malaysia: Tighter Monetary Policy	AFF	40
Taiwan: Inflationary Concerns Force the Central Bank into Action	SLO	42
Thailand: That Elusive Soft Landing	AFF	44

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REGIONAL SURVEY
THE COLLAPSE OF SUBCONTINENT SOCIALISM?

Until recently, the economies of the Indian subcontinent seemed determined to fly in the face of world opinion. While communism was collapsing in the Soviet Union and Eastern Europe, the subcontinent clung doggedly to its socialist baggage and continued to extol the virtues of Fabian systems put in place at the time of independence. In reality, however, subcontinent socialism merely succeeded in producing inefficient, bureaucracy-laden economies that stiffled entrepreneurial activity, and failed to increase significantly real per capita income for the majority of the population. Nevertheless, attitudes do at last seem to be changing. Sri Lanka and Pakistan have embraced free market policies in the last couple of years, and now Bangladesh and the sleeping giant of India appear to be moving down the same path. This path could be fraught with difficulties given the vested interests in the old system, but assuming these difficulties can be overcome, the enormous potential of the subcontinent could finally start to be realised.

TABLE 1

COMPARATIVE ECONOMIC DATA

	INDIA	PAKISTAN	SRI LANKA	BANGLADESH	SUBCONTINENT
Population (1991, Mn)	844	112	17	116	1,089
Average Population Growth Rate (1982-91)	2.2%	3.1%	1.4%	2.7%	2.3%
GDP (1991, US$ Mn)	247,813	37,245	8,925	22,562	316,545
GDP Per Capita	294	333	525	195	293
Average GDP Growth Rate (1982-91)	5.7%	6.2%	2.1%	3.3%	5.5%
Current Account Deficit as a % of GDP	2.5%	5.7%	4.6%	4.3%	3.1%
Government Budget Deficit as a % of GDP	8.4%	8.8%	12.0%	11.5%	8.8%
External Debt as a % of GDP	19.1%	33.9%	53.0%	49.0%	24.0%

Table 1 contains a selection of figures that demonstrate the magnitude of the subcontinent and the shared problems of its inhabitants. The combined population of India, Pakistan, Sri Lanka and Bangladesh is almost 1.1 billion and is growing in excess of 2% per annum. Real GDP growth has picked up somewhat over the 1980s, but continues to struggle to exceed signficantly the rate of population increase, with the result that per capita income remains below US$300 per annum. All four countries have tended to run significant current account and government budget deficits, and with the exception of India, have high rates of external indebtedness.

Most of these shared problems stem from similar roots in failed economic policies that emphasised protectionism, import substitution, nationalisation and central planning. The outcome was predictable. A financial system characterised by inefficient credit allocation, controlled interest rates and bureaucratic interference, and a bloated public sector, resulted in low rates of investment and a stagnation of industrial output. This lack of efficient investment both from domestic and foreign sources (foreign direct investment was actively discouraged) meant that the subcontinent missed out on the export-led growth surge of south east Asia. Today, subcontinent exports as a percentage of GDP are only 8% compared to a figure of 40% for the NIC and ASEAN economies.

A number of factors have combined to bring about the radical changes in policy seen in recent times. First the failure of socialist economies worldwide could not be totally ignored by the subcontinent and especially in the case of India, had direct consequences via the loss of substantial barter trade with the former Soviet Union and eastern Europe. Second, economic growth only sufficient to keep up with population growth meant that more people started to question the status quo. Third, the losses of the state-owned sector were a constant, excessive and ever-increasing drain on government resources. Finally, rising external debt combined with meagre export performance resulted in governments struggling to meet their increasing debt service payments with diminishing foreign exchange reserves (Chart 1). In fact it was this spectre of debt default -- the subcontinent generally has an exemplary record in this area -- that was the main catalyst for economic reform (helped by gentle and not-so-gentle prodding from international lending agencies).

Table 2 outlines some of the economic reforms put in place in the last couple of years. As can be seen, Sri Lanka and Pakistan lead the way, although the Indian and Bangladeshi reform programmes have accelerated in recent months. This section of the article will examine how the various economies have responded to economic reform so far, and how they can be expected to perform in the future. It also deals with the likely path and pace of reform in the next couple of years.

TABLE 2

ECONOMIC REFORM IN THE SUBCONTINENT

	INDIA	PAKISTAN	SRI LANKA	BANGLADESH
Price & Subsidies	Many prices are still controlled, but since July 1991 they have been raised significantly and a number of subsidies have been either withdrawn or abolished.	The majority of reforms were introduced in early 1991. Certain products still attract subsidies but the number has been reduced substantially. Most prices are now free from controlled.	The liberalisation of prices started in 1988 and most administered prices and subsidies have now been removed.	All price subsidies have been removed over the last 2 years, although a number of prices are still controlled.
Taxation	Top income tax rates were cut from 55% in July 1991 to 45% and are now 40%. The agricultural sector pays no tax and evasion is widespread. Corporate tax is expected to be cut from 50% to 40% in the next budget.	Maximum income tax rates have been cut from 55% to 35%. Tax collectors discretionary powers are being curtailed and a source of funds disclosure moratorium is in operation. No agricultural taxation.	The maximum income tax rate has been reduced to 35%. Corporate tax is set to fall to 35% from 50% , and a VAT is to be introduced in 1993 to widen the tax base.	Few changes except for the introduction of a 15% VAT in June 1991.
Money & Credit	Lending rate ceilings have been abolished and corporate yields are market determined. Government and deposit rates are still controlled. 40% of total credit is allocated to "priority sectors". Banks are subject to a Statutory Liquidity Ratio of 30% of deposits, although this has come down recently from 38.5%.	Interest rates have been freed and a government bond market is being developed. In July 1992, credit ceilings and controls are to be abolished and open market operations introduced. All distinctions between local and foreign banks have been removed.	Interest rates have been freed and T-bills have recently been introduced. Private banks freely determine their own lending policies, although state-owned banks are still subject to government directives.	Interest rates are still controlled and credit is allocated. However, controls are due to be relaxed in the near future. A central bank bill market is in an early stage of development.

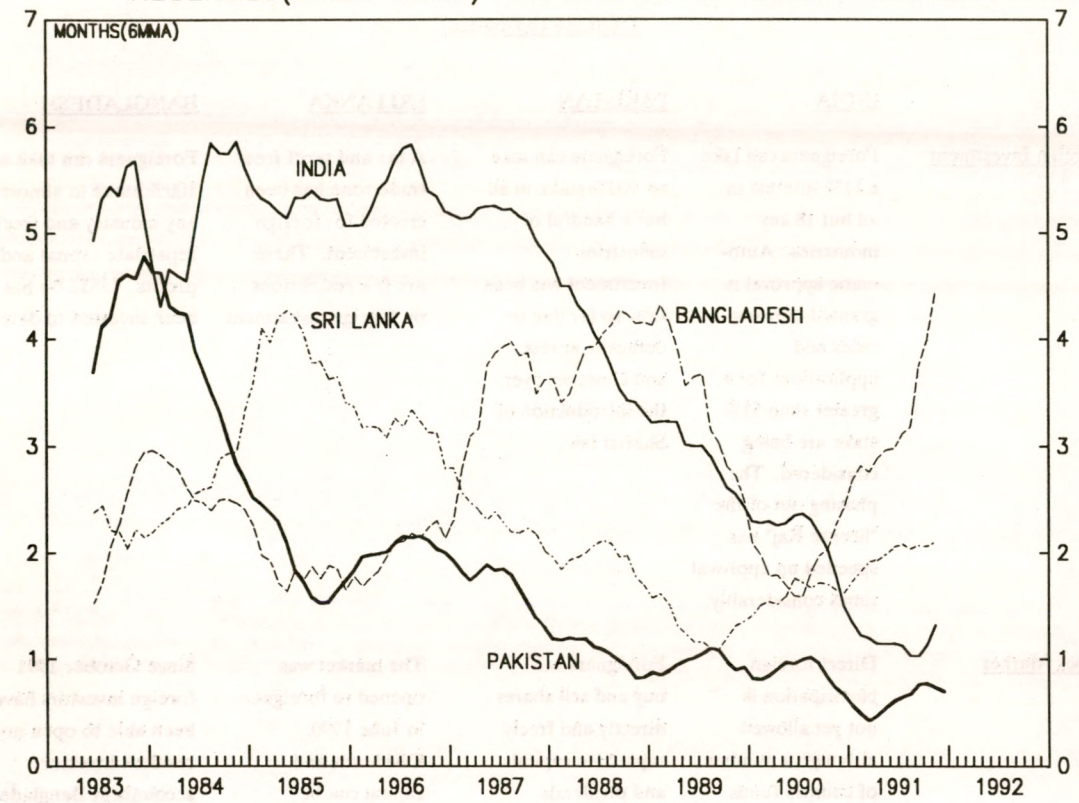
TABLE 2 (continued)

	INDIA	PAKISTAN	SRI LANKA	BANGLADESH
Currency	The Rupee was made 60% convertible on current account transactions in April 1992. Full convertibility is planned within 3-5 years, although the signs are that this could occur well within this timescale.	The Rupee has been freely convertible since February 1991.	The Rupee has been made convertible and exchange controls were ended in late 1991.	The Taka is still fairly heavily controlled although exchange controls for Bangladeshis were relaxed in July 1991. The current aim is for 60-70% convertibility.
Trade & Tariffs	Import licenses were abolished in March 1992. The maximum tariff rate has fallen from 200% to 110%.	Import licenses are only required for a very few items. Maximum tariff rates have been cut to 90% from over 100%, and will fall to 50% by 1994.	Import licenses are only required for a very few items. Maximum tariffs are now 50%.	Various import licenses are still in place although the number of items subject to licensing has been reduced. The maximum tariff rate of 100% is to be reduced to 75% in July and ultimately to 35%. Tariff rates fell from 150% last year.
Privatisation	Little progress so far although only 7 industries will definitely remain in the public sector.	50 firms out of 115 will have been sold or partially sold by June 1992. Initially the process stalled but it is now gathering pace.	6 privatisations have been completed and another 30 are being prepared. Eventually, 100 firms are to be returned to private ownership.	Since 1975, 370 firms have been privatised and 40 more are planned for 1992.

TABLE 2 (continued)

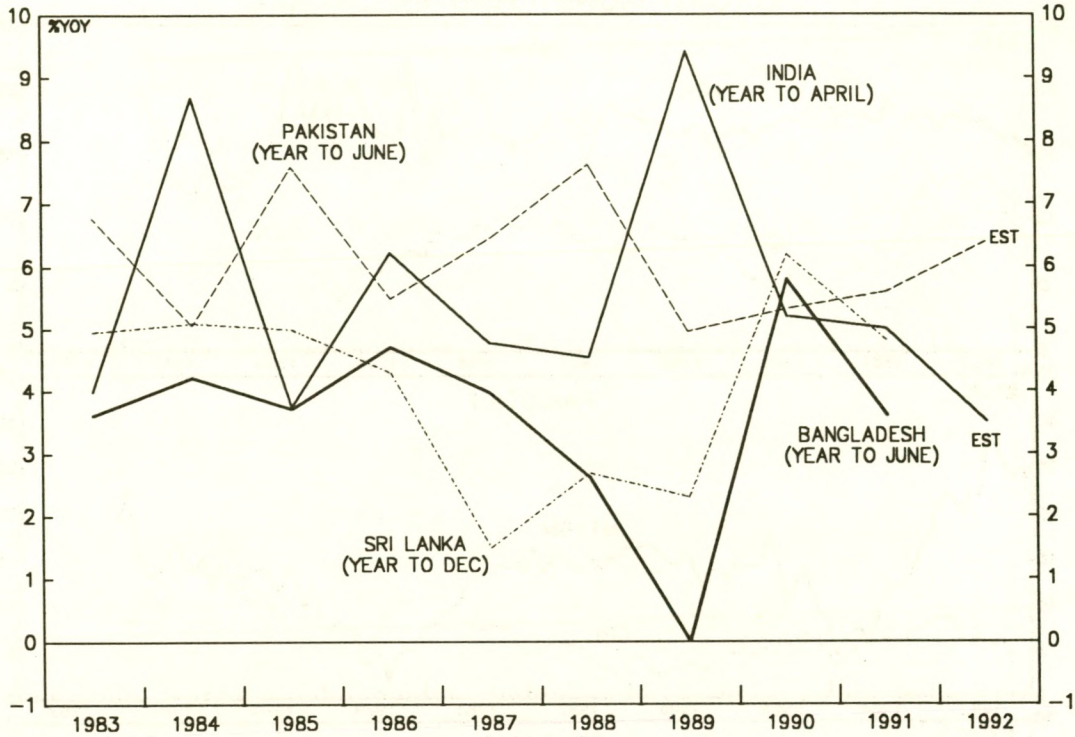
	INDIA	PAKISTAN	SRI LANKA	BANGLADESH
Foreign Investment	Foreigners can take a 51% interest in all but 18 key industries. Automatic approval is granted in many cases and applications for a greater than 51% stake are being considered. The phasing out of the "license Raj" has speeded up approval times considerably.	Foreigners can take an 100% stake in all but a handful of industries. Investment has been slow so far due to domestic unrest and concerns over the introduction of Shariat law.	A tax and tariff free trade zone has been created for foreign investment. There are few restrictions on foreign investment.	Foreigners can take an 100% stake in almost any industry and freely repatriate capital and profits. US$2 bn has been invested to date.
Stock Market	Direct foreign participation is not yet allowed although a number of country funds already trade and overseas convertible bonds are to be launched. Direct investment by "respectable overseas financial institutions and pension funds" is under discussion.	Foreigners can buy and sell shares directly and freely repatriate capital and dividends.	The market was opened to foreigners in June 1990. Dividends and capital can be freely repatriated and stamp duty has been abolished.	Since October 1991 foreign investors have been able to open non-resident investor accounts at Bangladeshi banks and purchase shares on the Dhaka stock exchange. Poor administration, and a 20% dividend tax have largely discouraged foreign participation so far.

REGIONAL SURVEY: CHART 1
RESERVES(MINUS GOLD) PER MONTHS OF IMPORTS COVER

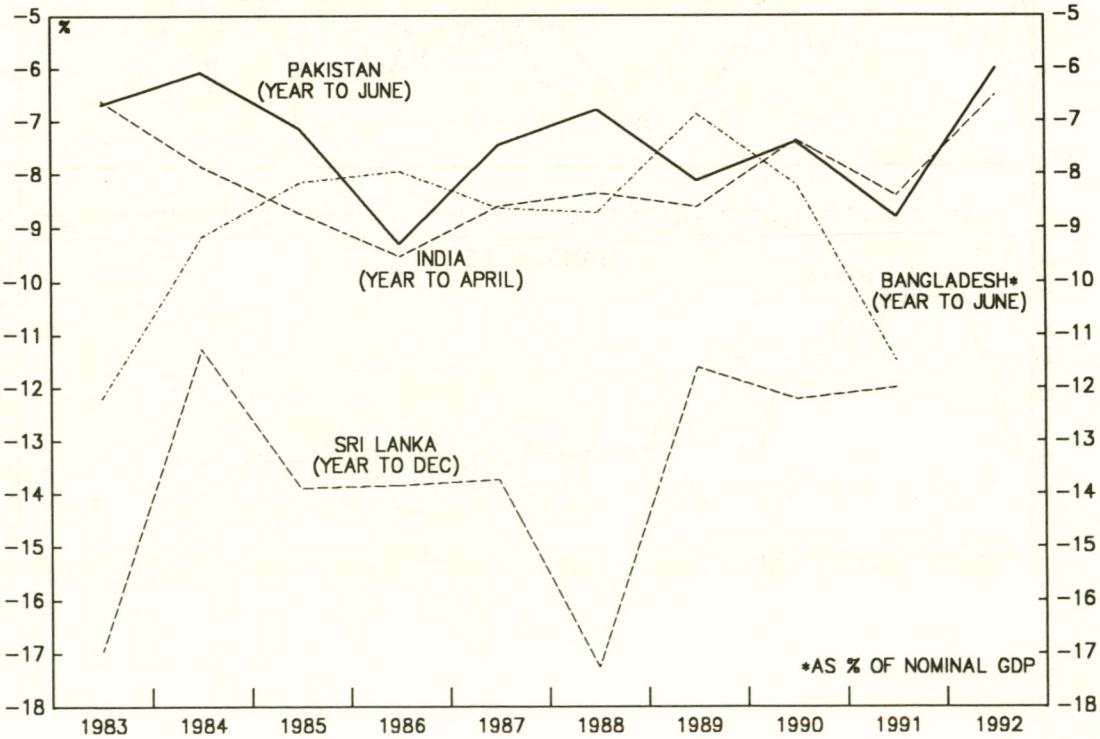


The early years of reform have not, perhaps predictably, been accompanied by a surge in economic growth (Chart 2). Nevertheless, it is encouraging that real GDP has continued to expand at rates approaching the decade average given the (relative) fiscal and monetary discipline adopted in recent times. India's annual growth rate over the 1980s is a distinct improvement over the sub-4% expansion of the preceding three decades, and this jump can be mainly attributed to the initial reforms of the early Rajiv Gandhi years. The consolidation of the more radical and far-reaching liberalisation being put in place now could easily result in potential growth rates of 6-8% after the initial adjustment stage. However, growth has slowed slightly in the year to April 1992 as the effects of a tight monetary policy, fiscal deficit reduction and the loss of Soviet bloc trade have filtered down through the economy. Pakistan, by contrast, has shown little variation in growth rates as fiscal policy has remained loose and Soviet bloc trade is minimal. The 1990 rebounds in growth in Sri Lanka and Bangladesh can be explained by an improvement in the law and order situation and a recovery from natural disaster respectively. However 1991 demonstrates how the vagaries of climate significantly influence economic performance. Sri Lanka's slowdown was caused by drought while Bangladesh again suffered from serious flooding. Similarly, India's economy can be devastated by a poor monsoon and after a number of good years, poor rains could be overdue.

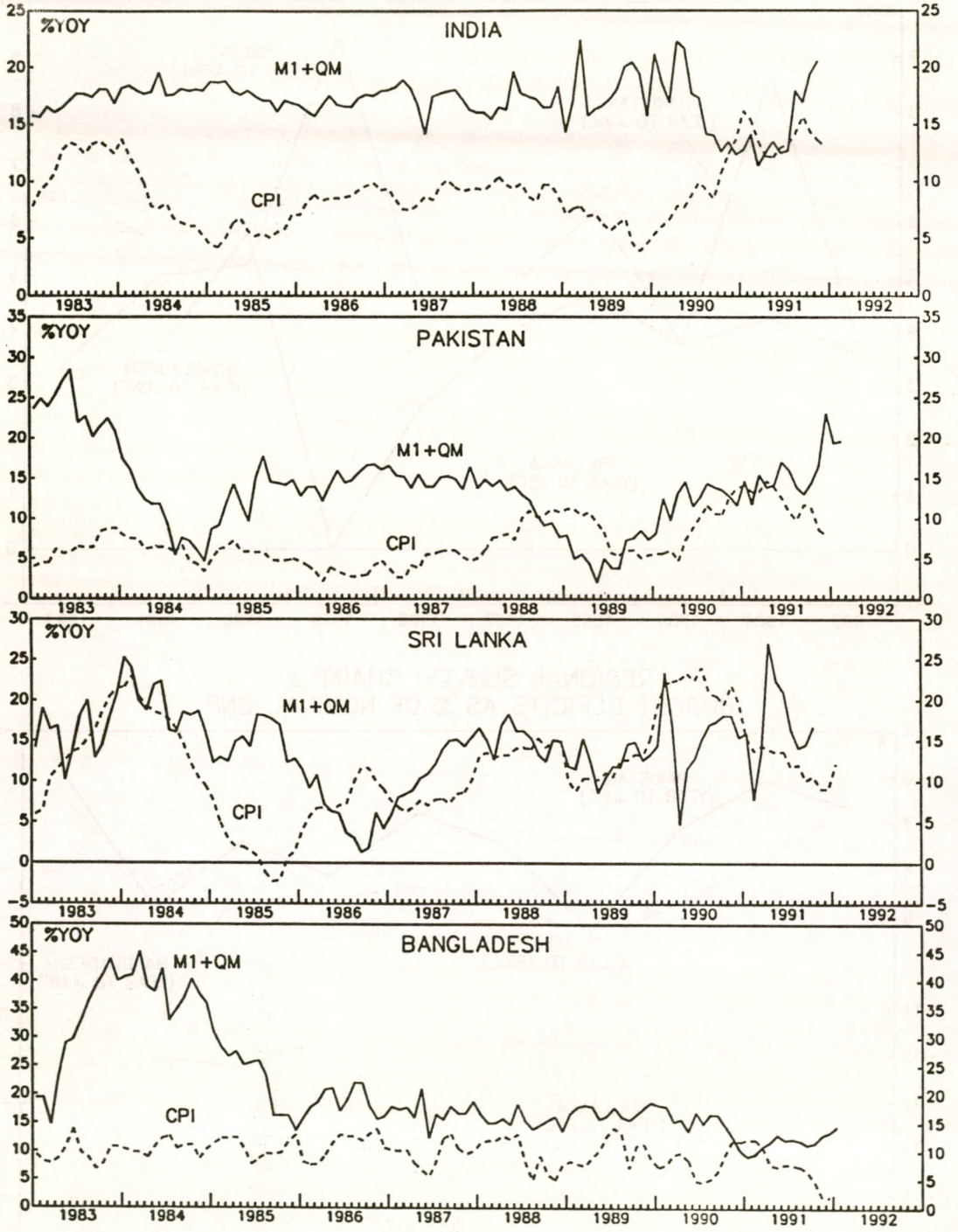
REGIONAL SURVEY: CHART 2
REAL GDP GROWTH



REGIONAL SURVEY: CHART 3
BUDGET DEFICITS AS % OF NOMINAL GNP



REGIONAL SURVEY: CHART 4
BROAD MONEY AND INFLATION



The most urgent task for the subcontinent is budget deficit reduction (Chart 3). The average consolidated deficit -- central and local government -- stood at 8.8% of GDP for fiscal 1990-91, and rarely dipped below this level throughout the 1980s. The deficits have been a function of a meagre tax yield on one side, and excessive military spending, subsidies, loss-making state-owned enterprises, bloated bureaucracies and rising debt service on the other. Meanwhile the rise in these current and recurring expenditures has necessitated equivalent reductions in much needed capital expenditures.

In general, deficits have fallen slightly over 1991 and 1992 as a result of subsidy withdrawals and tentative privatisation. However, the real battle is to reduce items such as defence expenditures and bureaucracy (which requires political willpower), and debt service (which is a function of overall deficit reduction and payment restructuring). For example, Pakistan's powerful military absorbs 44% of government revenues and debt service absorbs a similar amount. Similar figures are 18% and 39% for India, and 16% and 72% for Sri Lanka. Figures for Bangladesh are unavailable.

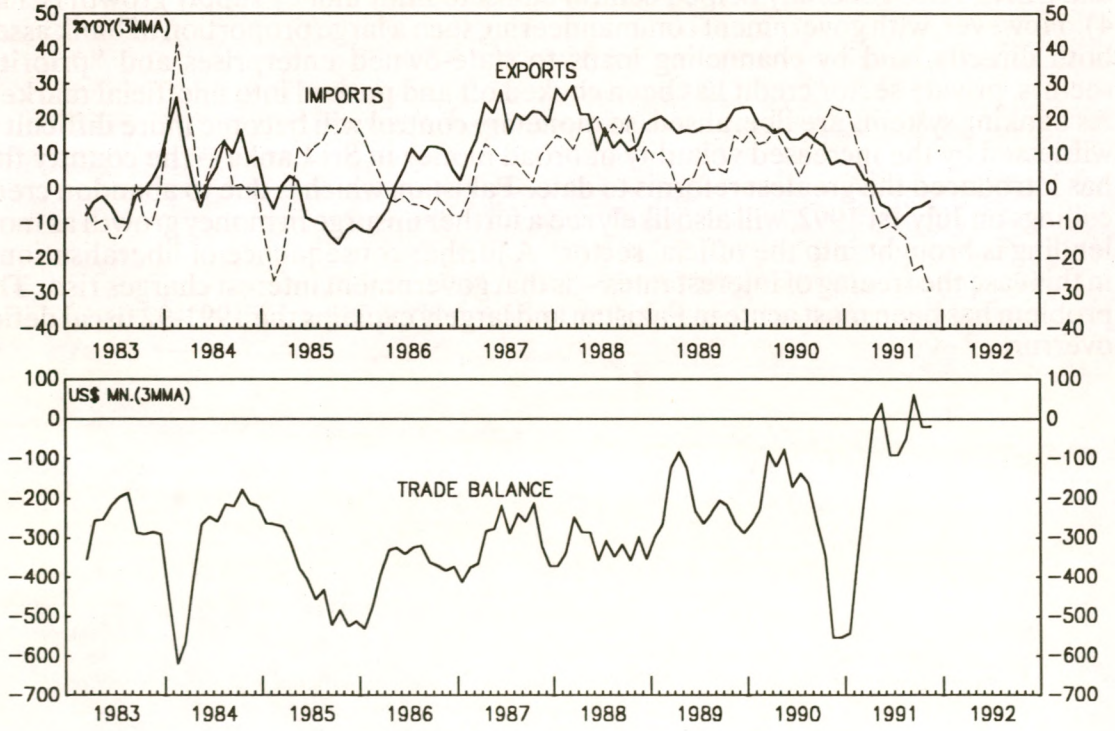
Aside from a natural interventionist bent, structural fiscal deficits can in part explain the high incidence of government control and ownership of subcontinental banking systems. Central banks are afforded little independence as they are often required to monetise government debt. Similarly, commercial banks are subject to extremely high statutory liquidity ratios (SLR) -- the amount of government paper that has to be held as a proportion of deposits. SLRs in India and Pakistan are around 30%, for example. Banks have also been left with large numbers of non-performing, public sector and agricultural loans.

Allocative credit policies, controlled interest rates and high cash reserve ratios and SLRs, have generally helped central banks to limit money supply growth (Chart 4). However, with government commandeering such a large proportion of bank assets both directly, and by channeling loans to state-owned enterprises and "priority" sectors, private sector credit has been choked off and pushed into unofficial markets. As banking systems are liberalised, so monetary control will become more difficult as witnessed by the increased volatility of broad money in Sri Lanka -- the country that has introduced the greatest reforms to date. Pakistan, which is due to abandon credit ceilings on July 1st 1992, will also likely see a further upsurge in money growth as more lending is brought into the official sector. A further consequence of liberalisation -- in this case the freeing of interest rates -- is that government interest charges rise. This problem has been most acute in Pakistan and largely explains the 1991-92 fiscal deficit overrun.

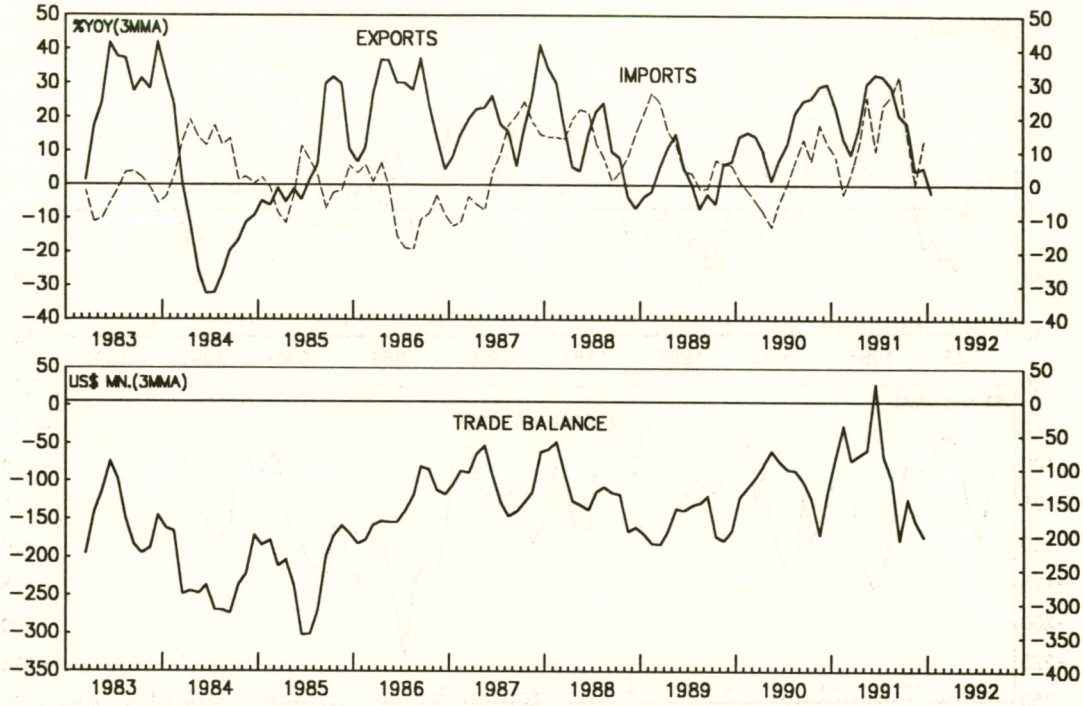
Banking reform leading to faster money growth when combined with price decontrols and subsidy withdrawals, is not a recipe for lower inflation (Chart 4). What the reform process does imply though, is a pick up in private investment and industrial activity. This should be further aided by the relaxation of foreign investment restrictions and a more benign trade regime. Once again, this could lead to a temporary worsening of current difficulties. The first effect of tariff reductions and the abolition of import licensing will likely be a surge in imports. However, the vast majority of imports will tend to be inputs for production and capital goods -- especially if they are associated with increased foreign direct investment -- while a surge in consumer good imports is highly unlikely. It will only be at a later stage that this new investment can be expected to translate into increased export growth, and thus in the interim, trade and current account deficits will likely deteriorate (Charts 5-8).

Worsening external deficits, however, should not place excessive downward pressure on foreign exchange rates (Chart 9). The downward drift can be expected to continue in most cases but incremental current account deficits should be able to be financed mainly via inflows of foreign investment and not via borrowing. As a result, foreign exchange reserves (Chart 1) should start to increase from their current low levels. There has already been a rebound in Sri Lanka since 1989 but Pakistan, by contrast, has failed to attract significant capital inflows with its open-door investment policy. The general explanation is that the introduction of Shariat law and severe law and order problems have deterred foreign investors, although it should be noted that domestic unrest is in some ways equally bad in Sri Lanka. In the case of India, the uptick in reserves is wholly attributable to IMF and other donor injections, while Bangladesh's relatively healthy position is almost entirely dependent on foreign aid.

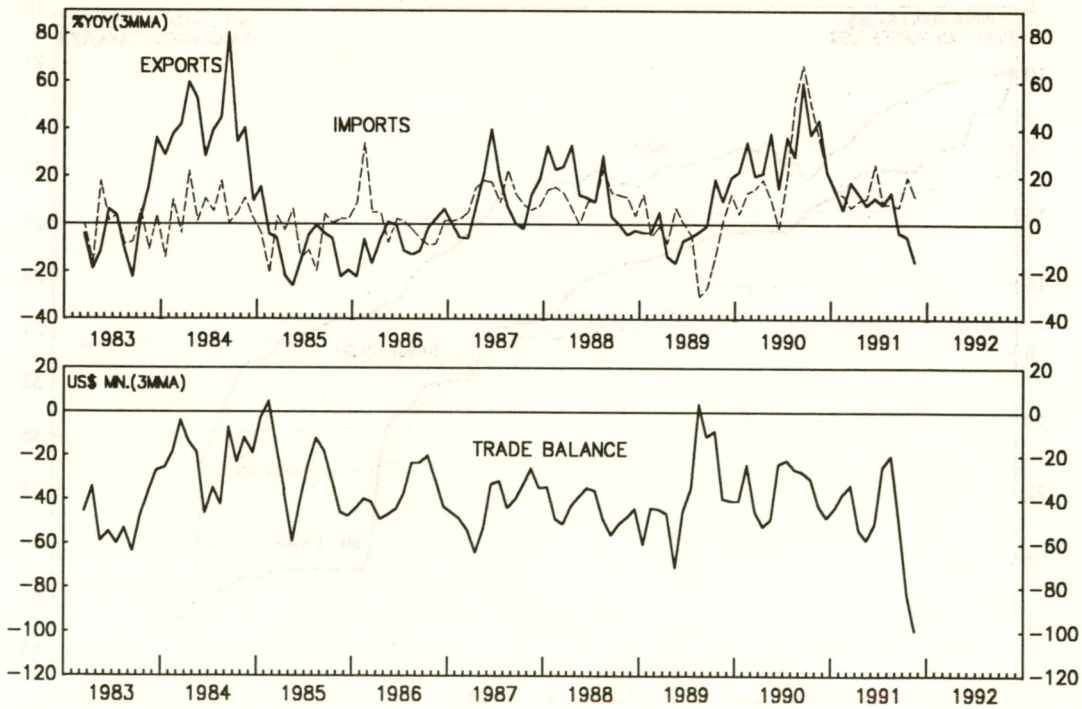
REGIONAL SURVEY: CHART 5
INDIA: TRADE PERFORMANCE



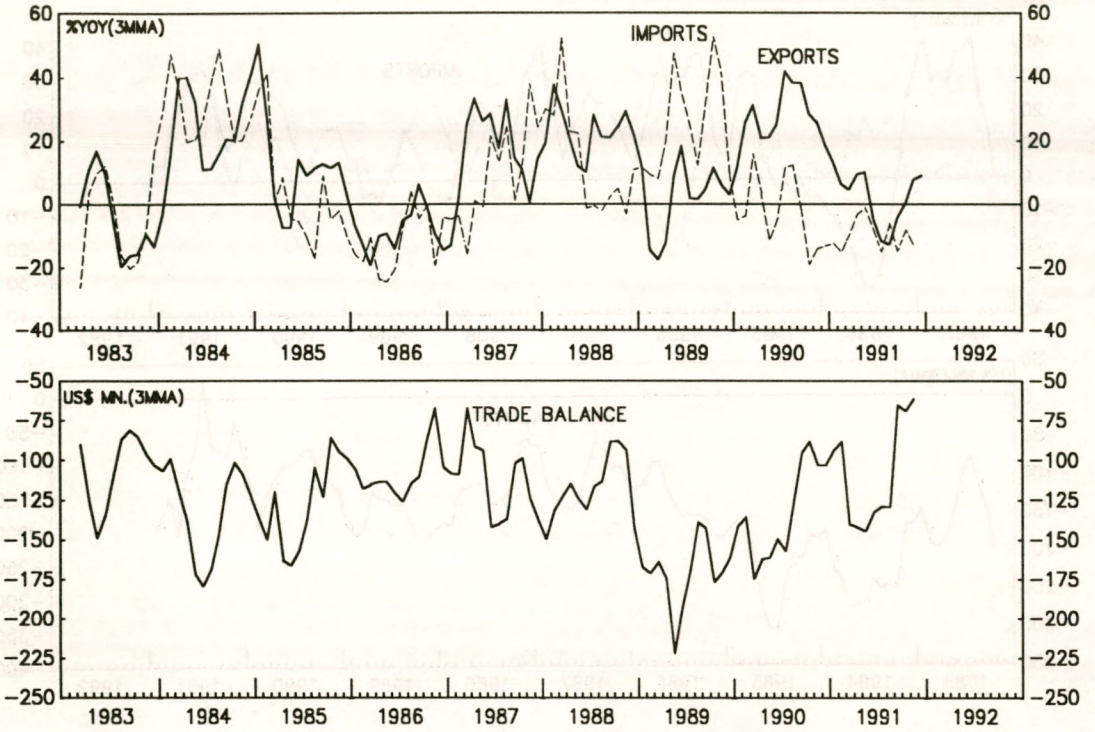
REGIONAL SURVEY: CHART 6
PAKISTAN: TRADE PERFORMANCE



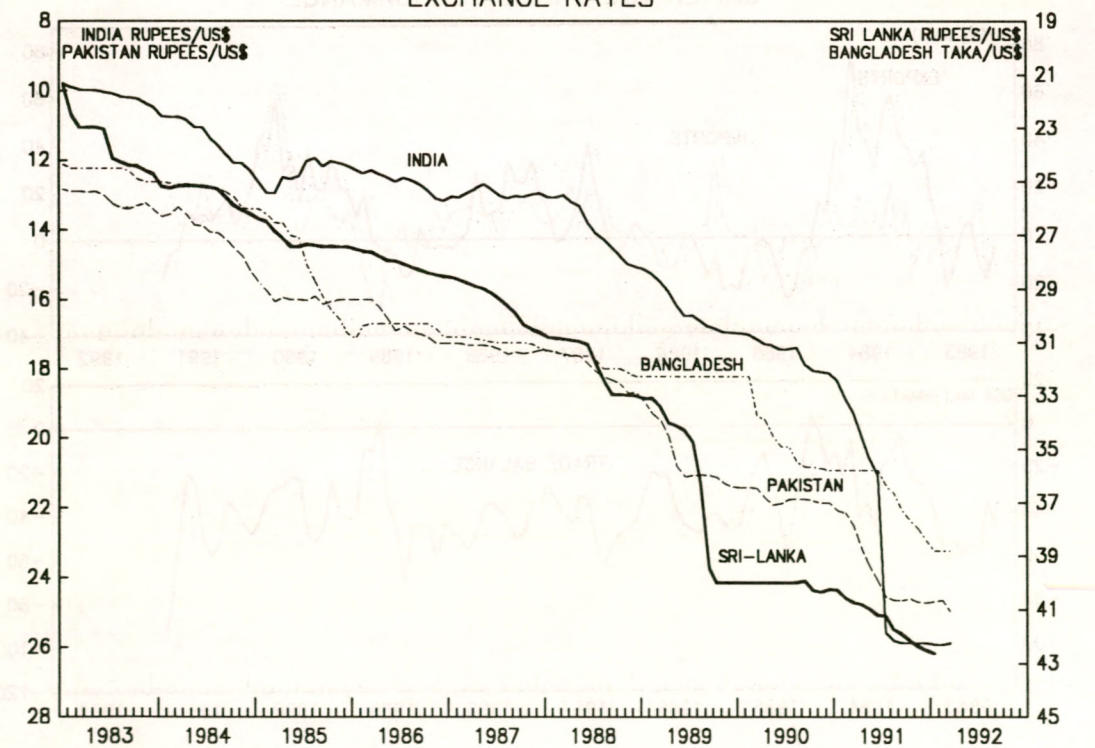
REGIONAL SURVEY: CHART 7
SRI LANKA: TRADE PERFORMANCE



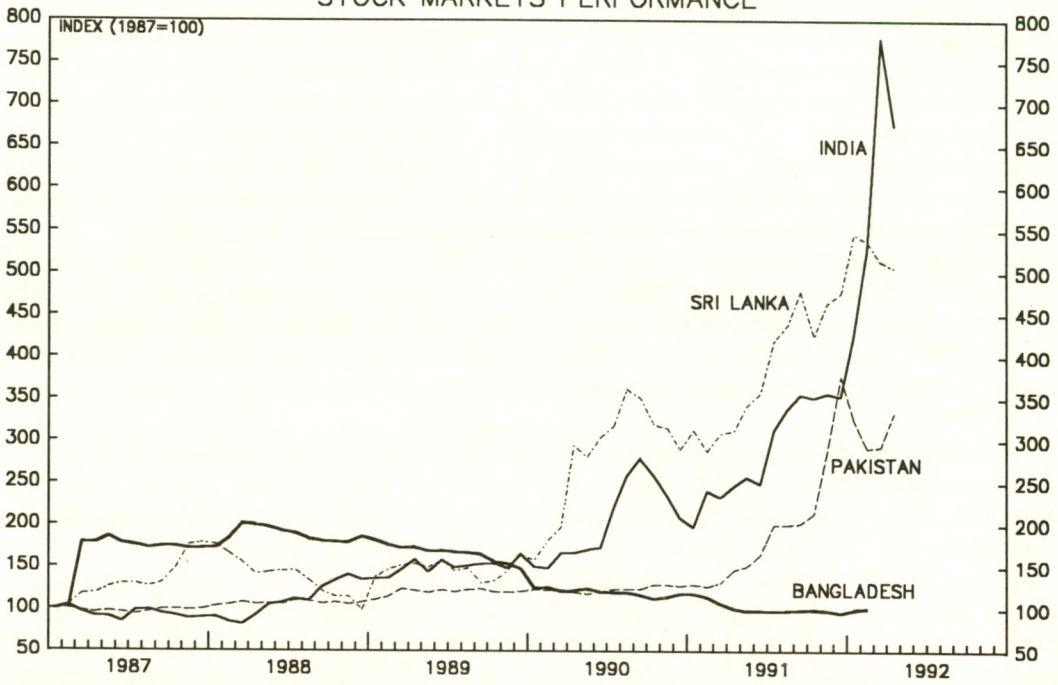
REGIONAL SURVEY: CHART 8
BANGLADESH: TRADE PERFORMANCE



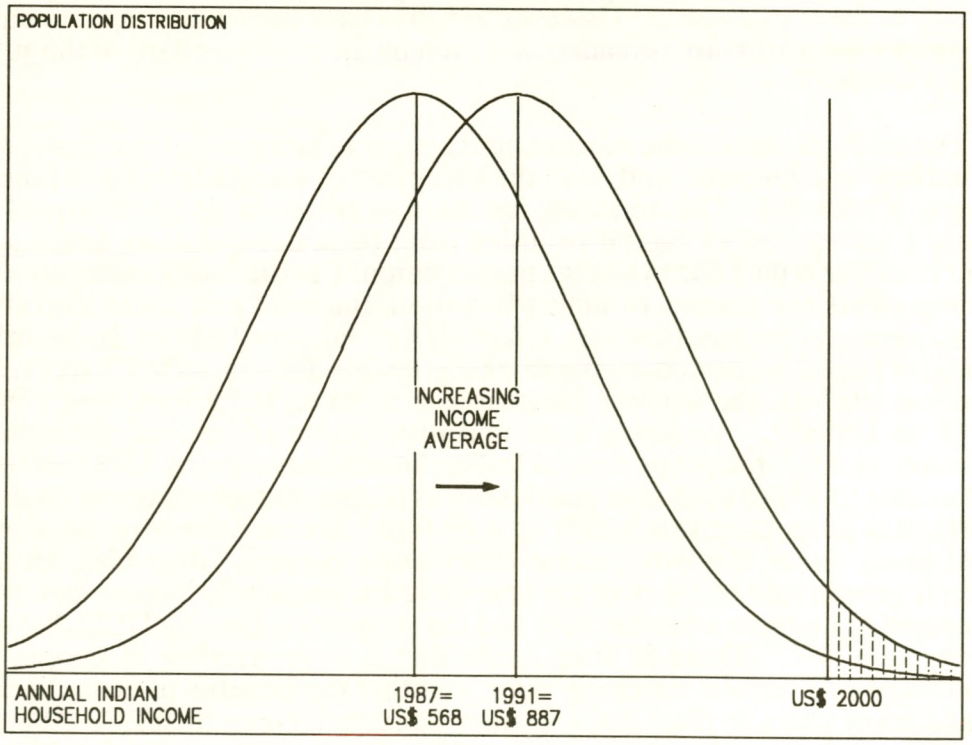
REGIONAL SURVEY: CHART 9
EXCHANGE RATES



REGIONAL SURVEY: CHART 10
STOCK MARKETS PERFORMANCE



REGIONAL SURVEY: CHART 11
THE WEALTH EFFECT



SUMMARY AND CONCLUSION: The task of dismantling subcontinent socialism has been a tortuous process to date, and is likely to involve economic deterioration and envoke much resistance in the near term. The broad themes that have already emerged, or can be expected to emerge in the near term are: (1) a pick up in inflation as price controls are relaxed, and banking systems are deregulated resulting in faster monetary expansion, (2) narrower budget deficits as tax collection is improved, subsidies are withdrawn, bureaucracies are trimmed and loss-making state-owned enterprises are privatised, (3) rising debt service costs as interest rates are freed, and (4) wider current account deficits as import restrictions are relaxed. However, assuming the reform process is not railroaded by vested interests or military intervention, the longer term benefits should include: (5) an inflow of foreign direct investment and technology transfers leading to more rapid industrialisation and improved export capacity, (6) a rise in domestic investment and increased financial intermediation, and (7) greater access to overseas funding and a recovery in foreign exchange reserves.

Of the four countries surveyed, Sri Lanka has made the greatest strides towards a free-market economy, although it has achieved little in the way of fiscal deficit reduction. However, reform seems well entrenched and there is little political risk of policy reversals. Pakistan has rapidly caught up with Sri Lanka in the last year, and in some ways has overtaken its rival, but the political and military risk is perhaps greater and the country suffers from a poor external image as a result of (perceived) rising Islamic fundamentalism. India's reform programme has accelerated almost beyond belief in recent months and it is likely to be the major beneficiary of foreign investment inflows into the subcontinent. Nevertheless, nowhere is the bureaucracy more entrenched than in Delhi and the test will come when privatisation and bureaucratic rationalisation start in earnest. Finally, Bangladesh has the cheapest labour costs of the four and its new industrial policy is already starting to attract foreign interest, especially in the textile sector. However, reforms have been fairly tepid to date, and the country's infrastructure is inadequate even by the poor standard of the subcontinent as a whole.

The stock markets of the subcontinent appear to believe that the moves towards free-markets will continue, and, with the exception of Bangladesh, have reacted accordingly (Chart 10). This re-rating has been in response to an improved profits outlook, a falling cost of capital resulting from bank deregulation, and a surge in market turnover in part due to foreign participation. For the foreign investor, the subcontinent offers the themes of industrialisation, financial and trade liberalisation, faster economic growth and low cost, relatively well-educated labour. It also offers the potential of huge domestic consumer market growth as illustrated by Chart 11. During the period 1987-91, the average household income in India increased 56% from US$568 to US$887. Assuming a normal distribution of income throughout the population, in 1987, the proportion of Indian households earning US$2,000 or more and thus able to afford consumer goods such as fridges and television sets was 0.24%. By 1991, this proportion was 1.43% or a six-fold increase (compare the size of the shaded areas under the two income distribution curves). Assuming an average economic growth rate of 7% over the next six years, household income can therefore be expected to increase a further 50% and the proportion earning US$2,000 or more will rise to 9.34%. There is little doubt that a huge number of people on the subcontinent will remain extremely poor, and that the benefits of economic reform will take many years to filter down in their direction. Nevertheless, the benefits to economy as a whole, and to the aspiring middle-classes in particular, should convince the policy makers that the route they have chosen is the correct one. Subcontinent socialism will not disappear without a struggle, but its eventual collapse seems well assured.

HONG KONG
REAPPRAISING THE IMPORTANCE OF CHINA IN THE ECONOMY

Introduction

A previous article in AMM (Vol. 15 No. 5, Sept.-Oct. 1991) examined the role of re-exports in Hong Kong's trade in general, and those to China in particular. A further important aspect of that topic was the relocation of Hong Kong's manufacturing base to the southern provinces of China, and especially to Guangdong. During the last four years there has been a rapid growth in the proportion of the China-related trade, whether domestic exports, re-exports, or imports which involved Outward Processing (OP).

OP for exports implies that goods will be processed in China and then re-exported to Hong Kong. For imports, OP implies that these goods were initially exported from Hong Kong to China for processing and now are being imported back to Hong Kong. (See Box 1 for the relevant definitions).

These trade flows are quite complex as they involve re-exports from and to China as well imports from China which originated as exports from Hong Kong. The importance of OP related flows rests on the fact that industrial or manufacturing processes carried outside Hong Kong may cause a loss of value added to Hong Kong equal to the factor incomes generated outside Hong Kong, ie wages, rents and profits. The word "loss" is used with a degree of caution because the relocation of Hong Kong's industrial base to China can be shown to yield direct and indirect benefits, the most important of which is the enhancement of the price-competitiveness of exports through the use of the cheaper labour force in China.

A further aspect, however, of all these developments is that the trading links, including the OP activities, are related directly and indirectly to China's trade with the US. In this sense the dynamics of these trade flows and their impact on Hong Kong's economy reflect primarily the economic cycles of the US rather than those of Chinese economy.

The aim of this article is to quantify these links and indicate the extent to which the economy of Hong Kong is still dependent on the US rather than on China. Furthermore the article will show that the importance attributed to China trade and the Chinese economy for the economy of Hong Kong requires careful intepretation. Suggestions that China is replacing the US as a key factor in Hong Kong's economy are shown to be misleading.

Disentangling the Trade Flows

Chart 1 shows that the trade with China measured on a simple basis (total imports from and exports to China divided by Hong Kong's total imports and exports) is now the most important component of Hong Kong's trade. Chart 1 also shows the rapid rise of re-exports from and to China as a proportion of this trade. However, as Chart 2 shows, the proportion of all these trade flows which are now related to OP has risen quite substantially since 1988 when statistics on OP trade started being collected. The Tree Chart updates and amplifies the information contained in the AMM article

BOX 1

It All Depends How You Define It

Domestic Exports are the natural produce of Hong Kong or the products of a manufacturing process in Hong Kong which has changed permanently the shape, nature, form or utility of the basic materials used in manufacture.

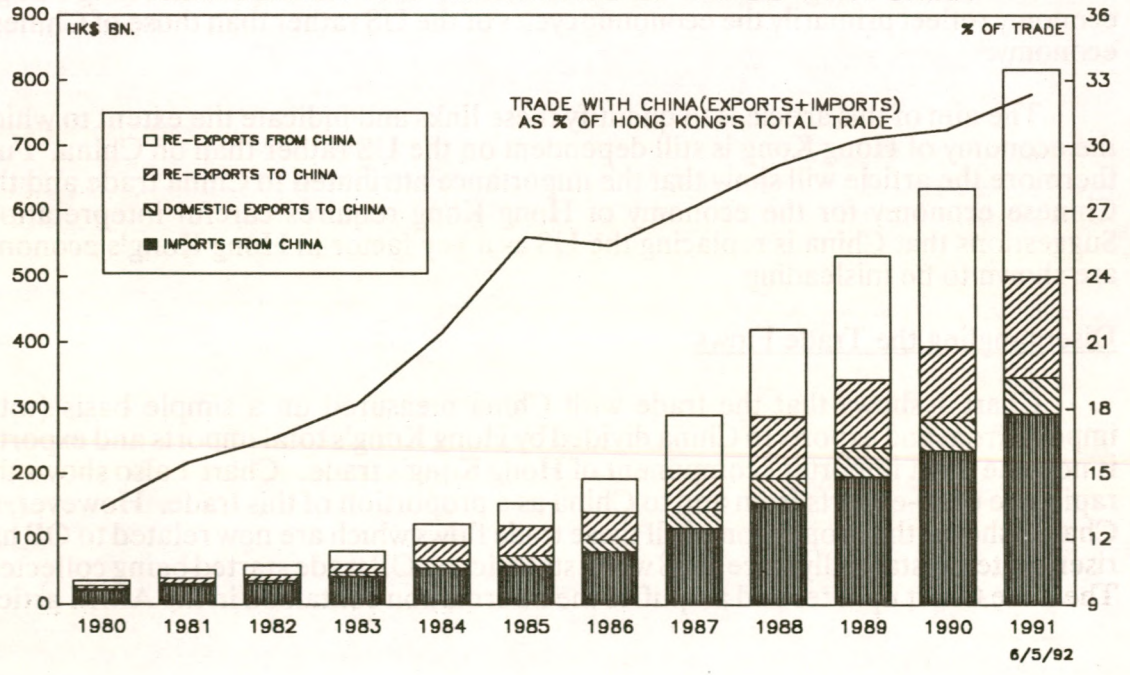
Re-exports are products which have previously been imported into Hong Kong and which are re-exported without having undergone in Hong Kong a manufacturing process which has changed permanently the shape, nature, form or utility of the product.

Outward Processing (Exports to China) are exports of raw materials and semi-manufactures (including near-finished goods) from or through Hong Kong to China for processing (including partial assembling, packaging etc.) with a contractual arrangement for subsequent re-importation of the processed goods into Hong Kong.

Outward Processing (Imports from China) are imports of goods from China of which all or part of their raw materials or semi-manufactures (including near finished goods) are under contractual arrangement exported from or through Hong Kong to China for processing (including partial assembling, packaging etc.)

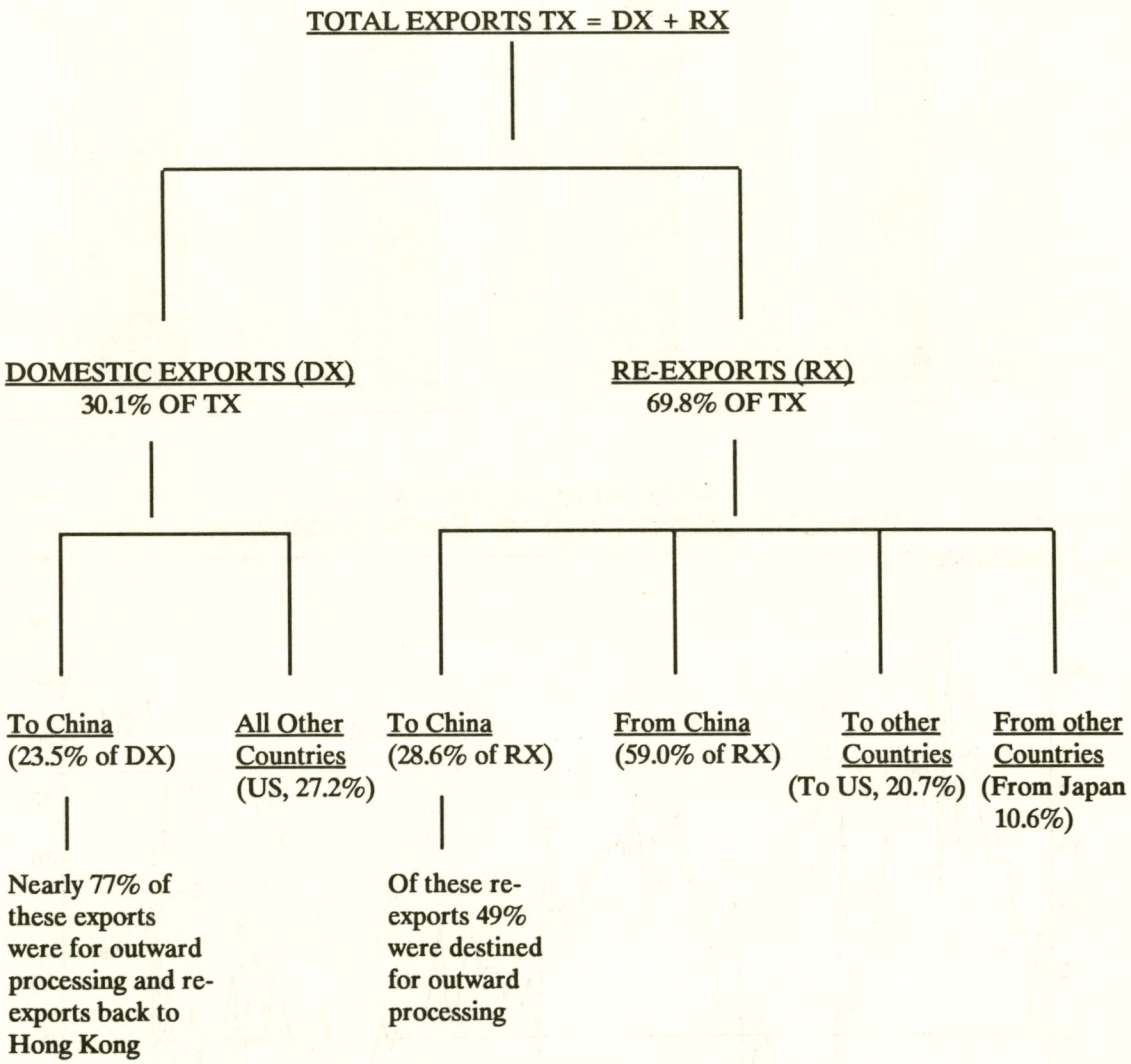
Source: Official definitions from Hong Kong External Trade and Hong Kong Monthly Digest of Statistics.

HONG KONG: CHART 1
COMPOSITION AND IMPORTANCE OF TRADE WITH CHINA



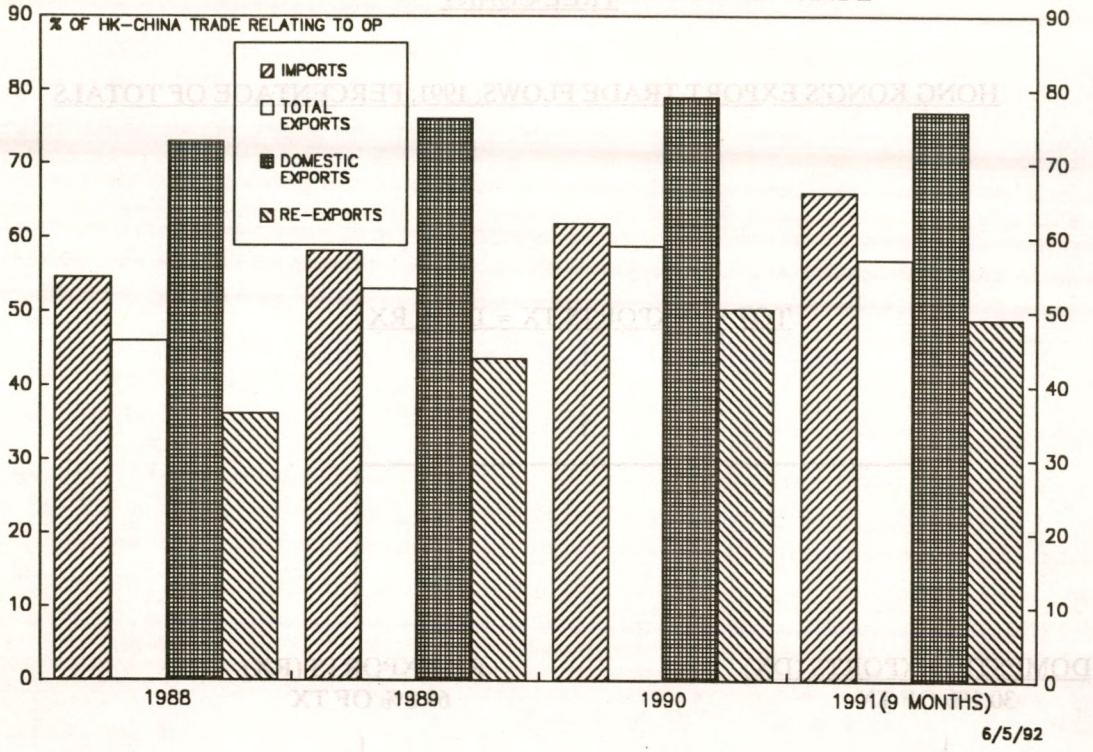
TREE CHART

HONG KONG'S EXPORT TRADE FLOWS, 1991, PERCENTAGE OF TOTALS

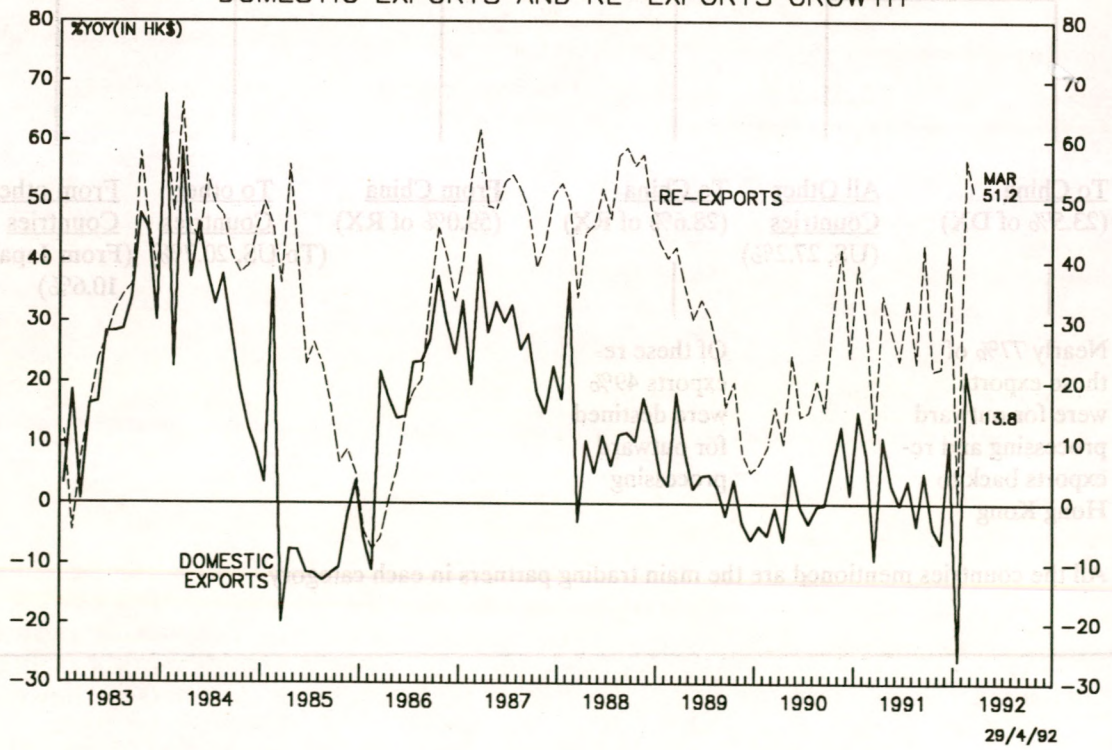


All the countries mentioned are the main trading partners in each category.

HONG KONG: CHART 2
IMPORTANCE OF OUTWARD PROCESSING TRADE



HONG KONG: CHART 3
DOMESTIC EXPORTS AND RE-EXPORTS GROWTH



referred to above. It also helps to put some classificatory order in what, at first sight, appears to be quite confusing flows and definitions.

Chart 3 illustrates the rate of growth of re-exports and domestic exports of Hong Kong. The large fluctuations at the start of 1992 reflect the distortions of the Chinese New Year. It is clear, however, that re-exports are growing faster than domestic exports. The latter are dependent on the growth of trade with the US, since that market absorbed 29% and 27% of domestic exports during 1990 and 1991 respectively. It is important to note, however, that re-exports now dominate Hong Kong's export trade (defined as exports plus re-exports). The share of re-exports rose from 56% in 1988 to 70% in 1991. Currently re-exports to China account for 28.0% of total re-exports, and re-exports from China stand at 59% of total. As Chart 4 shows, however, re-exports from China (NB nearly 60% of total) are dominated by re-exports to the US (in excess of 30%). Hence the relatively slow growth of domestic exports shown in Chart 3 is misleading as the China-related re-export trade is primarily HK-US trade "diverted" through China.

Chart 5 disaggregates some of data shown in Chart 4, but even here the interpretation of the rate of growth of domestic exports to China must allow for the OP component which is re-exports-related. Finally Chart 6 illustrates the rate of growth of re-exports from Hong Kong to the US. As Chart 4 showed over 90% of these re-exports originated from China.

Unfortunately, all these interdependent flows can easily confuse or distort the picture of the triangular trade between Hong Kong and China, and between Hong Kong (via China) and the US. Two boxes, 2 and 3 summarise these flows and quantify what is now obvious, that is directly or indirectly trade with the US in relative terms is still the most important component of Hong Kong's external trade. Box 2 summarises the overall position, whereas Box 3 introduces the role and importance of OP into the picture.

Reassessing the role of China

It must be stressed that the assessment of the importance of the US directly and indirectly to Hong Kong's export trade is done in relative terms. Simple estimates involving the percentage of domestic and re-exports trade accounted for by the US or China may yield a misleading picture. Consider the following calculations:

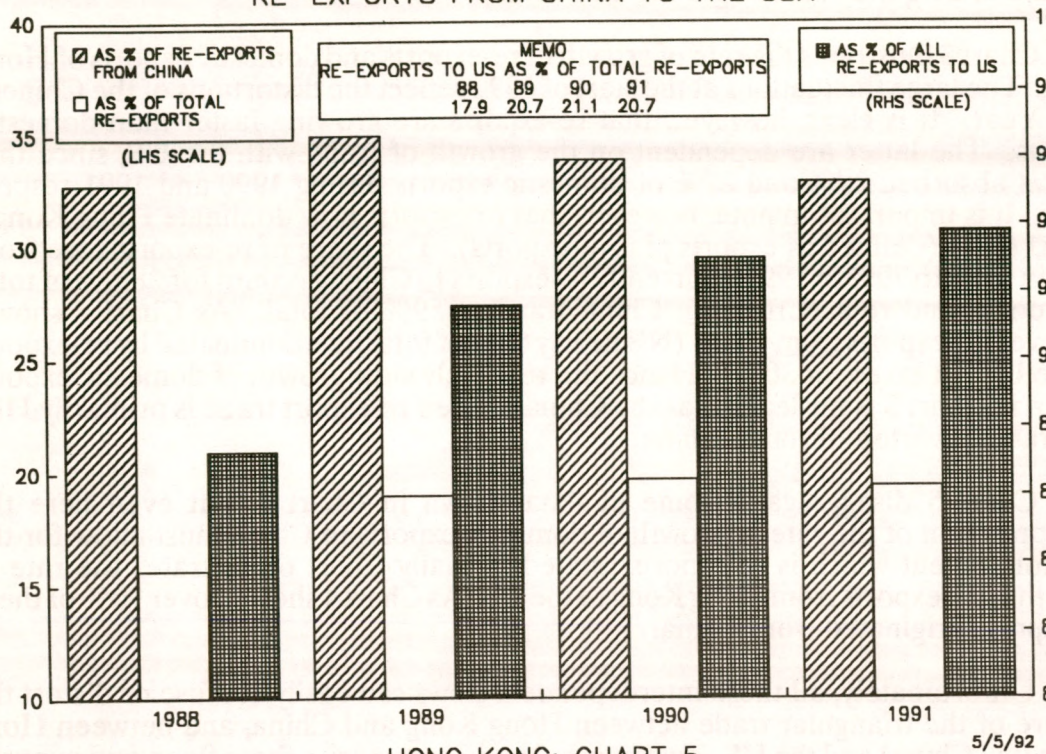
1991 (Figures in % of total)

	US	China
Domestic exports	27.2 (42.4)*	23.5
Re-exports to	20.7 (27.2)*	28.6
Re-exports from	4.9	59.0

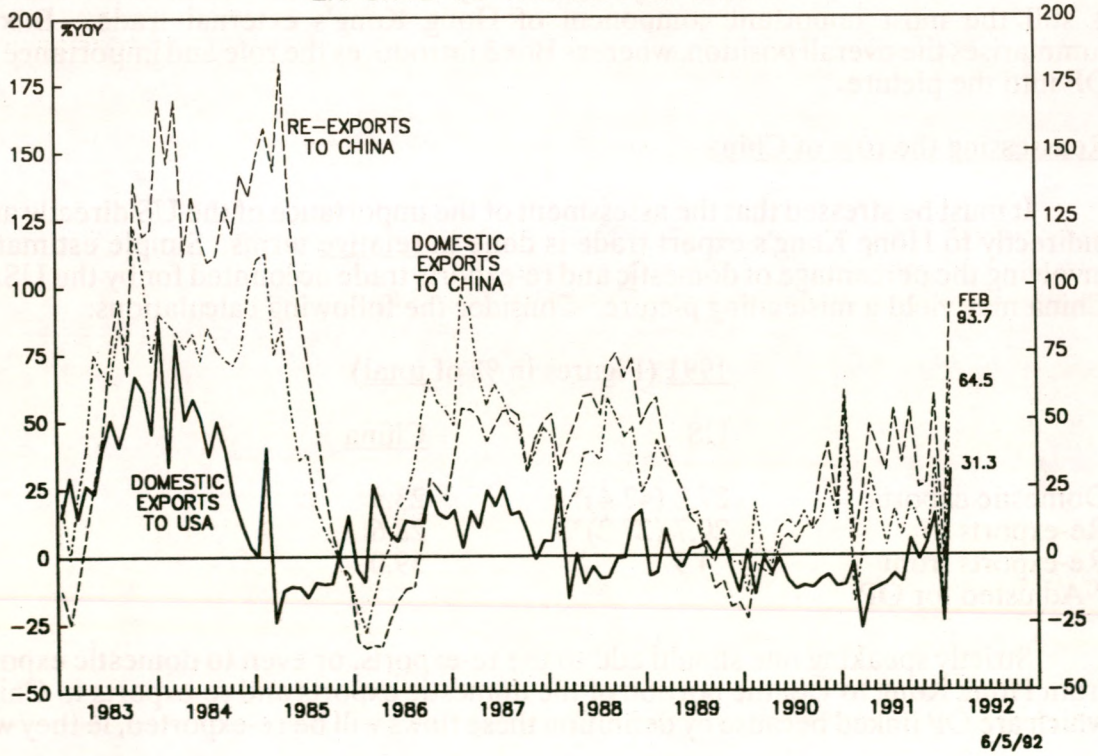
* Adjusted for OP

Strictly speaking one should add to the re-exports, or even to domestic exports from Hong Kong to US, the portion of the domestic exports and re-exports to China which are OP linked because by definition these flows will be re-exported, ie they will

HONG KONG: CHART 4
RE-EXPORTS FROM CHINA TO THE USA



HONG KONG: CHART 5
EXPORTS TO THE US AND CHINA



BOX 2

RE-EXPORTS AND THE HK-CHINA-US NEXUS

All figures refer to 1988-91 and are rounded

1. Re-exports rose from 56% to 70% of export trade.

2. Re-exports from China rose from 48% to 59% of total re-exports.

3. Re-exports to China account on average for 30% of total re-exports.

4. Re-exports from China to the US account on average for:

   (a) 18% of total re-exports
   (b) 33% of re-exports from China
   (c) Over 90% of all re-exports to the US

HENCE

Since re-exports now dominate Hong Kong's total trade (70%)
and since re-exports from China now account for 60% of all re-exports,
and since 30% of re-exports from China go the US,
then, US-related trade, in relative terms, is still the single most important trade flow for Hong Kong.

BOX 3

OUTWARD PROCESSING AND THE HK-CHINA-US NEXUS

All figures refer to 1988-91 (Q3) averages and are rounded.

1. 60% of all imports from China involve OP

2. Exports to China involving OP stand at 54% of total.
   Of these total exports
   (a) Domestic exports involving OP averaged 76%
   (b) Re-exports involving OP averaged 45%

By definition OP-related trade flows involve re-exports. Given the important role of the US in Hong Kong's and China's re-export trade, OP is another aspect of the developing links between the three countries.

appear as re-exports from China, and one third of these will go to the US. There is a risk of double counting here, since these re-exports may well appear as part of the re-exports from Hong Kong to the US. Worse than that, they may even appear as domestic exports from Hong Kong since what determines domestic exports is not necessarily the origin of the goods but the processes involved. It is important to note that the Trade Analysis Section of the Census and Statistics Department of Hong Kong has not released information concerning the percentage of re-exports in the domestic exports component, assuming, of course, that this information exists. The following calculations are, therefore, purely indicative in order to sketch out the sums and percentages involved:

		1991 (HK$ bn)
1.	Re-exports to China involving OP	75.12
2.	Domestic exports to China involving OP	41.89

3. Percentage of 1) and 2) above re-exported to US calculated on the basis that, on average, 30% of re-exports from China go to the US (75.12+41.89) x 0.30 = HK$35.1 bn

Assuming this sum of HK$35.1 bn to be either purely domestic exports (which is unlikely) or re-exports to the US, we arrive at the OP-adjusted figures indicated in the brackets (*) in the simple calculations shown above.

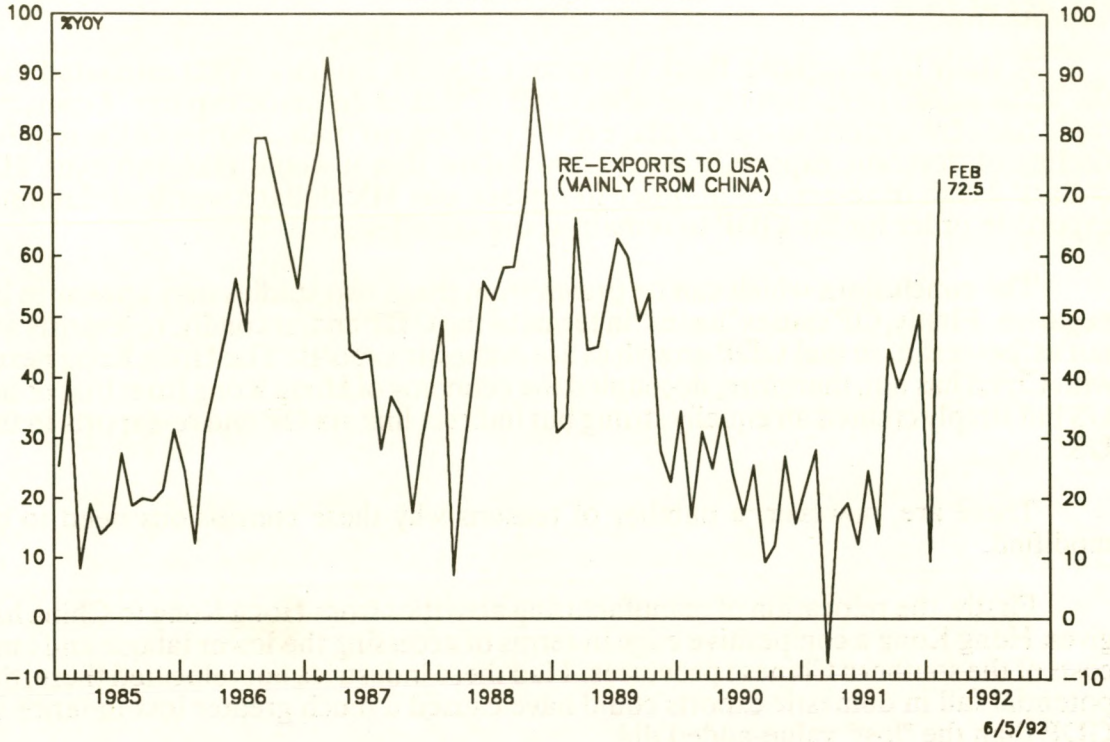
Without belabouring the obvious, these simple numerical exercises serve to emphasize that the US remains the single most important client for Hong Kong's trade and OP-related activities.

Chart 7 shows the fluctuations in Hong Kong's GDP growth rate and those of China and US. In relative terms it is tempting to attribute the upsurge in economic activity in Hong Kong since 1990 to the acceleration in the growth rate of China, given that by 1991 the US had entered a recession (negative GDP growth rates). As has been shown above the rapid rise in the Hong Kong-China trade is related more to the trade links with the US rather than the rise in aggregate demand in China. It is worth reiterating that at present in excess of three quarters of Hong Kong domestic exports to China are related to OP, ie these exports are not consumed or used in China. Nearly half of the re-exports to China also do not stay there either as they, too, are OP-related. Hence of the domestic exports of Hong Kong to China only a quarter, and of re-exports one half are linked to movements in aggregate demand in China. Without oversimplifying the picture, Hong Kong is using China's relatively cheaper factors of production to produce goods primarily for exports to the US. China is using the imports of capital and technical know-how from Hong Kong in order to create jobs, expand its share of world trade in general, and that with the US in particular.

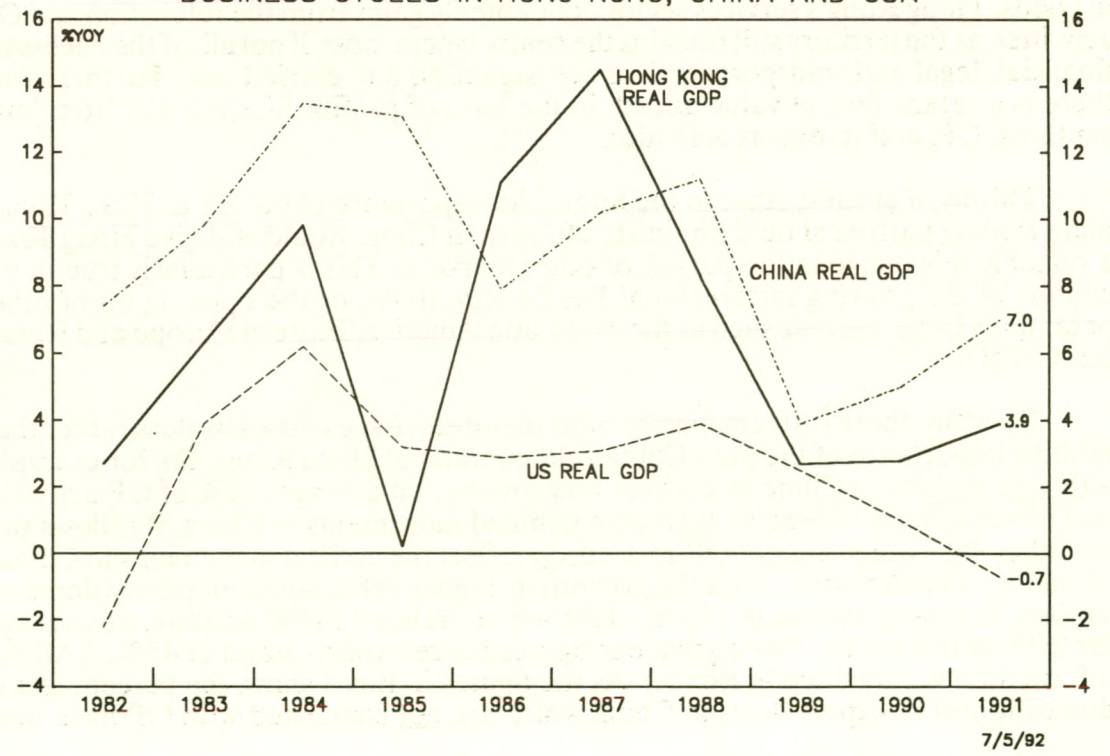
Questions of Value Added

In the previous AMM study on this topic it was shown that the relocation of Hong Kong's manufacturing base to southern China (ie the OP activities) caused a loss to Hong Kong's GDP. The estimate was based on the value added (wages, profits, rents)

HONG KONG: CHART 6
RE-EXPORTS TO USA



HONG KONG: CHART 7
BUSINESS CYCLES IN HONG KONG, CHINA AND USA



which was earned in China rather than in Hong Kong. This loss averaged 8.3% of GDP over 1988-90. A reestimation of this figure to include data for 1991 produced an average of 9.2%.

A study by Hongkong Bank (Economic Report, January 1992) estimated that the value added of re-exports was about half of that of domestic exports. Given the rapid rise of re-exports as a percentage of the total export trade, and hence the relative decline of domestic exports, it would now follow that it would take two extra HK dollars' worth of re-exports in order to replace one HK dollar's worth of domestic exports in order for the GDP to remain at the same level.

The conclusions which can be drawn from these two studies may appear to be negative. Firstly, OP causes "losses" in terms of the GDP and, secondly, re-exports are not as "powerful" to fuel GDP growth as are domestic exports. The Hong Kong nexus with China has not, therefore, decoupled the economy of Hong Kong from that of the US but simply created an equally strong but indirect link via OP and re-exports to the US.

There are, however, a number of reasons why these conclusions need to be modified.

Firstly, the relocation of manufacturing activities from Hong Kong to China has given Hong Kong a competitive edge in terms of accessing the lower labour and land costs of the southern Chinese provinces. Had these industries not relocated there, the potential fall in domestic exports could have caused a much greater loss in terms of GDP than the "lost" value-added did.

Secondly, these measurements of value added are based exclusively on the trade in goods. Hong Kong's services sector undoubtedly gains from the relocation and OP activities, as the territory still remains the centre where most, if not all, of the necessary financial, legal and transport services are organised and carried out. Furthermore, there is a return flow of value added in the form of profits, interest, etc. from joint ventures, OP, and re-export activities.

Thirdly, if at some stage in the future the importance of the US as Hong Kong's main trading partner should diminish, the base in China would still give Hong Kong a valuable advantage in the pursuit of other markets. This is particularly true in the context of the growing intraregional Pacific Rim trade, or the opening up of other potentially large markets such as those in Latin America, Eastern Europe and Russia (ex-USSR).

Fourthly, there still remains the most important issue of the absolute rather than relative importance of the pure China-related trade of Hong Kong. So, for example, although exports to China as a whole now involve, on average, 54% of OP activities and hence are <u>not</u> related to aggregate demand movements in China, it follows that the other 46% which are not OP-related, <u>do</u> reflect the cyclical movements in China's economy. Furthermore, given the potentially higher value added of purely domestic exports, domestic exports to China which are not related to OP account, on average, for 24% of this trade. The equivalent figures for re-exports stand at 45%. (All this information is contained in Box 3.) As the figures in Box 4 show, the percentages of domestic and re-export flows to China which are <u>not</u> connected with OP have been

following fairly closely the business cycle of China. As China's GDP growth peaked in 1988 both the percentage and rates of growth of these flows declined, but started to pick up again with the recovery during 1991. Since the business cycle of China is not, in general, in phase with that of the US (see Chart 7) this is an encouraging development for Hong Kong. Trade with China for Chinese consumption and use rather than for re-export, will represent an increasingly countercyclical force for Hong Kong as long as the Chinese business cycle is out of phase with those of ther major industrialised countries.

BOX 4

The share and growth rate of purely China-related exports from Hong Kong in total Hong Kong trade (%)

	1988	1989	1990	1991 (Q3)
Total Exports	14.5	12.0 (-4.0)	10.1 (-5.4)	11.6 (36.9)
Domestic exports	4.7	4.6 (0.7)	4.4 (-4.0)	5.4 (25.6)
Re-exports	21.9	16.8 (-3.6)	13.3 (-5.5)	14.6 (41.8)

Figures in brackets are yoy rates of growth. All figures are rounded.

SUMMARY AND FORECAST: The growth of Hong Kong's re-export trade reflects the growth of US-China and HK-US trade via Hong Kong. The development of OP activities is an integral part of these flows. In relative terms the dependence of Hong Kong on China is still less than that of Hong Kong on the US. The development of OP has had a net beneficial impact on Hong Kong both in terms of GDP growth and in enhancing the competitiveness of the territory in export markets. The business cycle of Hong Kong will be influenced by developments in the US as the US still remains its main trading partner. There are signs that purely China-related trade is growing again, although it accounts, on average, for about 12% of the total export trade. This is an encouraging development as it may provide Hong Kong in the future with a countercyclical balancing force as long as China's business cycle is out of phase with those of Hong Kong's other main trading partners.

NEW ZEALAND: RECOVERY AT LAST.

Introduction

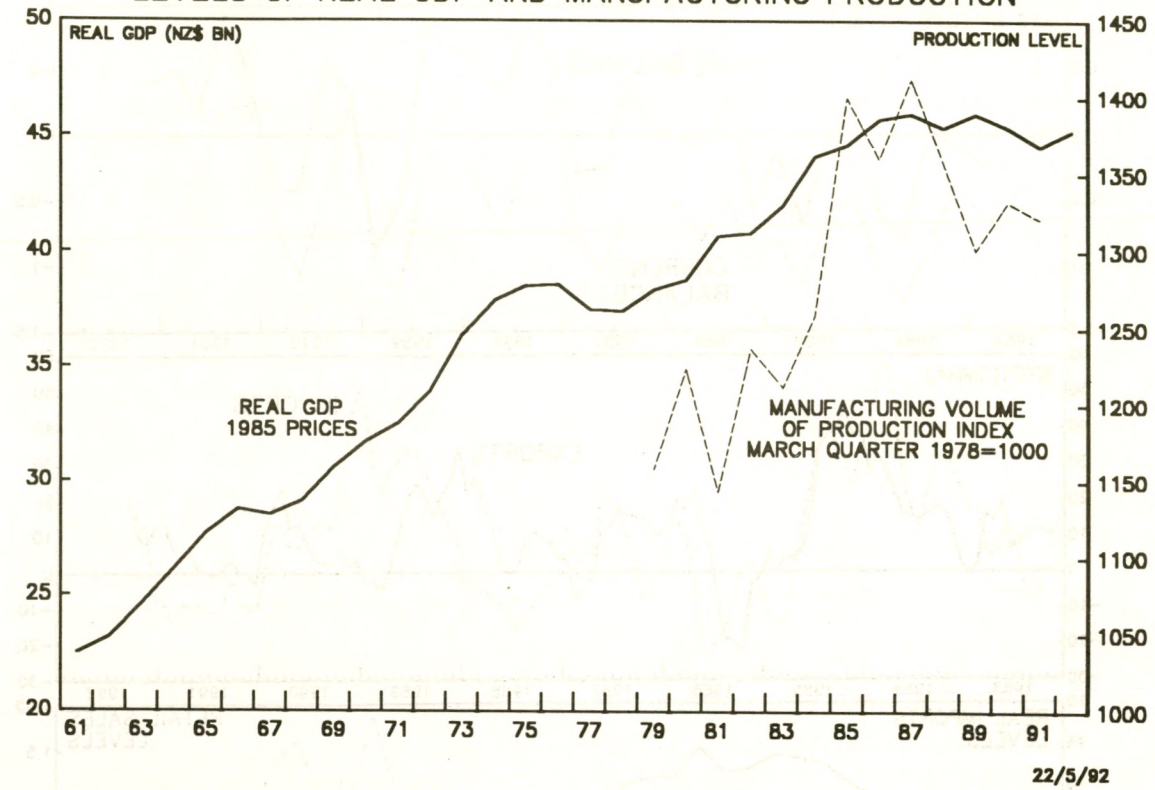
Starting in 1984, the Labour government of New Zealand embarked on a comprehensive economic reform programme. The tax system was massively overhauled, subsidies were abolished, and whole departments of government and state-owned enterprises were corporatised. The programme, known as Rogernomics, after the Minister of Finance, Roger Douglas, shifted the economy towards a more efficient, market-oriented structure. (See the Chronology of Main Economic Reforms, listed on pp. 36-39). The Labour government's reformist zeal has been given a new lease of life following the accession of the National Party to power in October 1990, with Ruth Richardson, the new Minister of Finance, taking the leading role in economic reform. Until recently the only evidence for the success of this radical programme was a sharp downturn in inflation. However, in the closing months of 1991 and the early months of 1992 the economy at last began to show signs of recovery. The long period of painful adjustment and restructuring is finally bearing fruit.

This article summarises the evidence suggesting the economy has turned the corner from recession to recovery and then considers some of the major factors which will influence the future strength and competitiveness of the New Zealand economy. The conclusion is that provided the government can significantly reduce the burden of taxation which supports unwarranted welfare programmes, state-run education and health systems, there is reason to be much more positive about the economic prospects for New Zealand than for many, many years. Unfortunately progress in reforming these areas is likely to be slow and could encounter prolonged resistance from the numerous vested interests affected. Nevertheless, just as under Mrs. Thatcher in Britain and under Mr. Reagan in the USA the policy of preventing the government's share of GNP from rising was sufficient to restore a substantial measure of confidence and energy to private business, so in New Zealand it is possible that the next few years of the reform programme will at last bring a real and sustainable upswing to the private sector after nearly five years of stagnation.

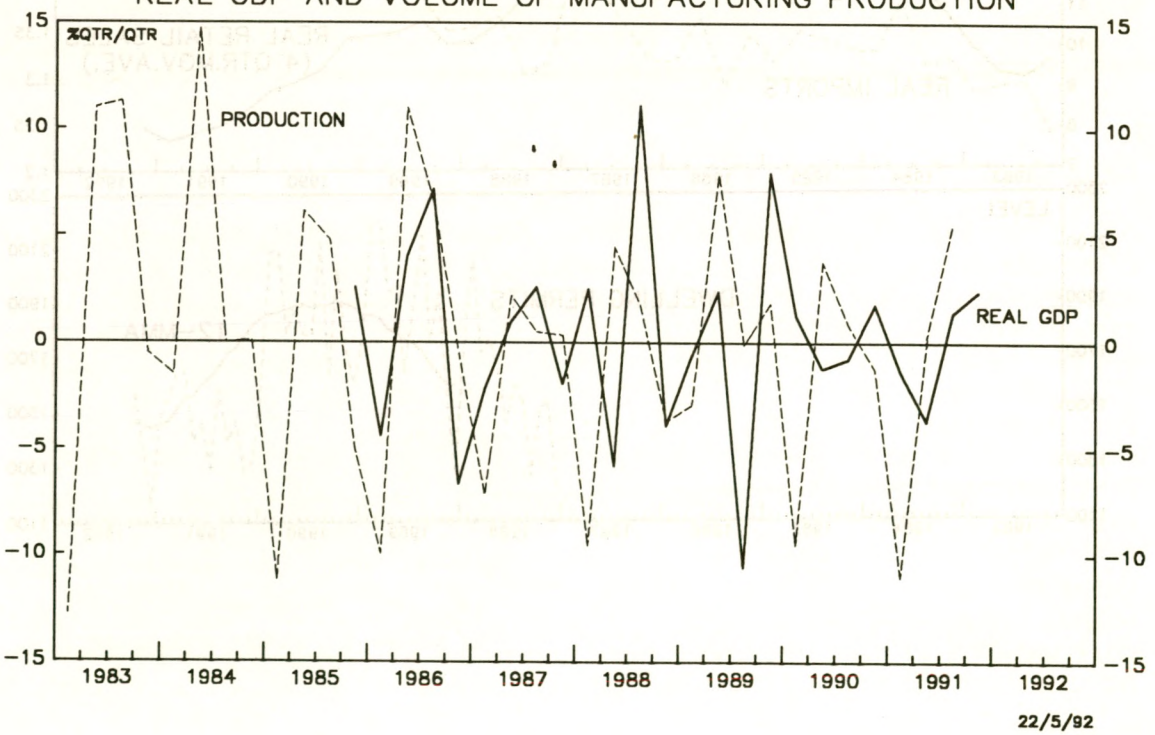
Evidence of the Upturn

Chart 1 shows annual real GDP data for New Zealand from 1961, and an index of manufacturing production volume from 1979. The data indicates that the economy had significant downturns in 1967 and in 1977-78, and that there has been virtually zero growth -- indeed some downturn -- since 1987. As government statisticians gradually assemble the data, private sector economists are coming to the view that the New Zealand economy troughed during the September quarter of 1991, and that the December quarter was probably the first quarter of the recovery. This would mean that the New Zealand recession had continued for 15 successive quarters since the third quarter of 1987. During the period from 1987 Q4 to 1991 Q3 real GDP has only ever turned upwards for two successive quarters at a time (see Chart 2). The remainder of the time has seen real GDP declining or flat. However, the real GDP data showed positive real growth in both the September and December quarters. The largest sector of domestic demand -- personal consumption -- saw an increase, enabling the wholesale and retail trades to record increases in value-added. Simultaneously there was a strong rise in real disposable income for wage and salary earners

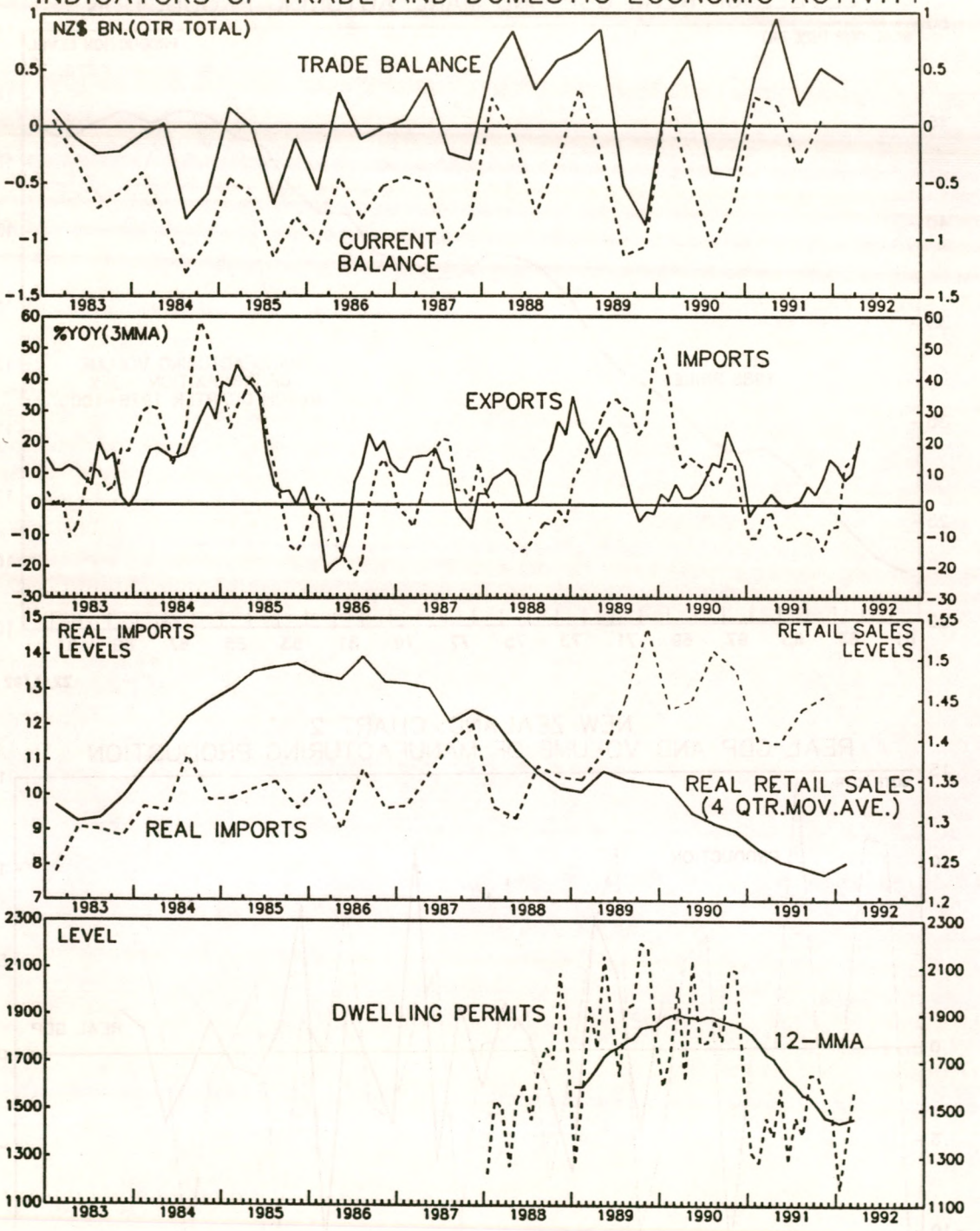
NEW ZEALAND: CHART 1
LEVELS OF REAL GDP AND MANUFACTURING PRODUCTION



NEW ZEALAND: CHART 2
REAL GDP AND VOLUME OF MANUFACTURING PRODUCTION



NEW ZEALAND: CHART 3
INDICATORS OF TRADE AND DOMESTIC ECONOMIC ACTIVITY



in the December quarter, assisted in no small measure by the fall in consumer prices over the period. Stronger household demand stimulated a rise in manufacturing output (Chart 2), and the start of an upturn in real retail sales (Chart 3).

The initial upswing in the domestic economy in the second half of 1991 was continued in the first quarter of 1992. Housebuilding activity rose especially strongly (+10.3%), and dwelling permits in March were up 7.4% on a year-on-year basis (Chart 3). Further declines in mortgage interest rates should sustain this trend. Car registrations were firm in January and February, but fell again in March. On the external side the picture is brightening. Exports rose by 4.7% over the whole of 1991 as compared with the whole of 1990, and in the three months February-April exports were up 20.7% compared with February-April 1991. The trade balance has shifted to surplus since early 1991 (thanks initially to the slump in imports, but thanks more recently to the export revival). (See Chart 3).

Finally, survey data from a variety of sectors also reveal a much more buoyant mood both among consumers and businessmen. First, the Westpac-McDermott-Miller index of consumer confidence rose a massive 17.4 points in the March 1992 quarter to 105.4 -- the biggest jump ever. A level in excess of 100 indicates optimism, in contrast to the sub-100 pessimistic levels of recent years. The most optimistic readings were in the export-led areas of the country, but optimism had also improved significantly in the metropolitan districts. Second, the Dun and Bradstreet survey of business expectations for the June quarter showed many indices at their highest levels for 10 quarters. For example the all-firms optimism index for new orders rose from 20% to 48%, and the index for profits rose from 34% to 50%. The retail sales sector indices were also up markedly. 57% of respondents expected sales to be higher in the June quarter. Third, the Institute of Economic Research's business confidence index is (remarkably) at its strongest level for nearly 20 years. Fourth, whereas domestic manufacturing sales were down 10.5% in 1991, the December quarter survey by the Manufacturing Federation showed that manufacturing exports would more than compensate for real domestic sales in the first half of 1992. In summary, the evidence both from measures of economic performance and from surveys of expectations indicates a higher level of economic activity and a much more buoyant mood than in the first six to nine months of 1991.

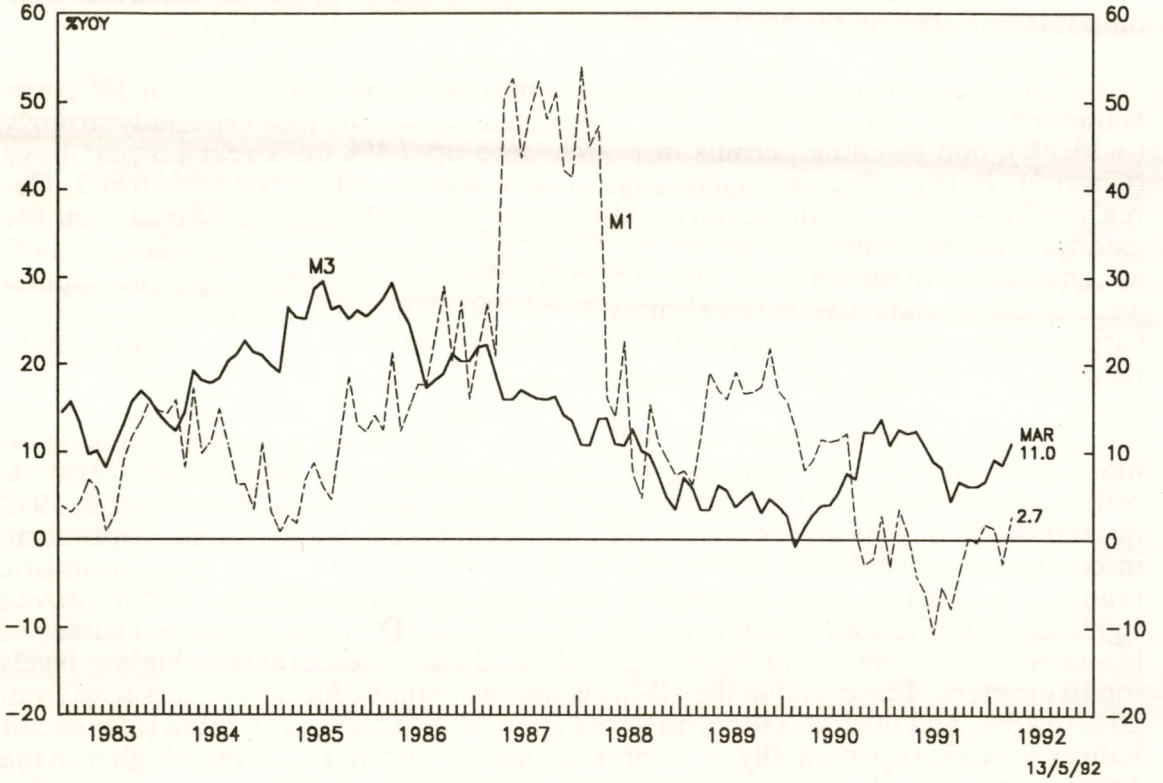
Factors Influencing the Sustainability of Recovery

Among the most important factors which will affect the durability of recovery in New Zealand are (i) the conduct of monetary policy, (ii) New Zealand's international competitiveness, and (iii) the size and role of government in the economy. We shall consider these factors in turn.

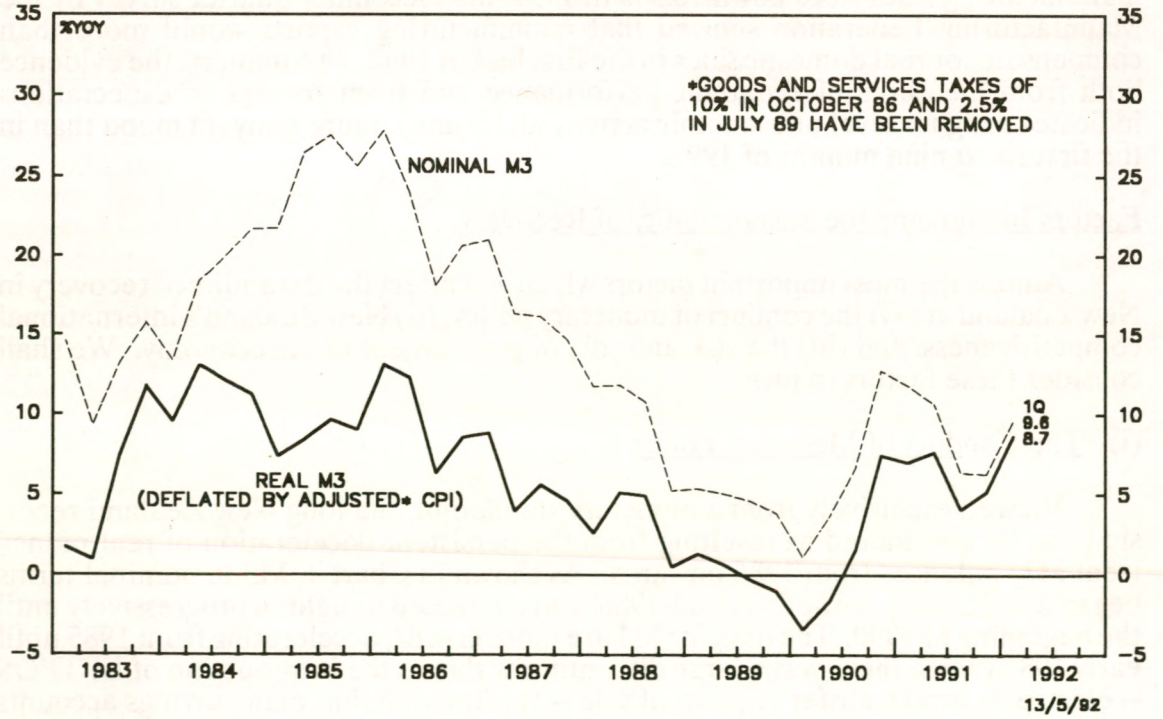
(i) The Conduct of Monetary Policy

Viewed exclusively from a monetary standpoint, the long New Zealand recession can be considered as resulting from the persistent deceleration of real money (real M3) balances from 1986 onwards. As shown in Chart 4, M3 in nominal terms began decelerating abruptly in mid-1986, and continued to tighten progressively until the beginning of 1990. The data for M1 are more erratic, accelerating from 1985 until early 1987 (when there was a large discontinuity due to the introduction of EFTPOS -- electronic fund transfer at point of sale -- facilities, so that many savings accounts

NEW ZEALAND: CHART 4
MONETARY GROWTH



NEW ZEALAND: CHART 5
NOMINAL AND REAL M3 GROWTH



previously only included in M3 became part of M1), but then decelerating equally sharply in 1988, and again in 1990 and 1991. As in many other economies, when there is doubt about which money aggregate to rely upon, we prefer to follow the broader indicator since this is also usually a better predictor of broad spending power and inflation. Looking at Chart 5 it is clear that real M3 continued to declerate almost without interruption until early 1990. Even without knowing about the enormous institutional changes in the New Zealand economy over the past eight years, such a deceleration would suggest prima facie grounds for a prolonged economic slowdown -- especially given the severity of the inflation rate (15.4%) in 1985.

Conversely, and again considering the evidence from monetary data alone, the solid upturn in real M3 since the second half of 1990 provided good grounds for believing that aggregate real incomes or purchasing power would be rising in New Zealand roughly one year subsequently. The data for real economic activity quoted in the preceding section certainly vindicate such a forecast. It is important to note, however, that a substantial amount of the recent upturn in real money growth is due to the decline in inflation rather than the increase in money growth alone. In 1990 Q1 inflation was 7.0% year-on-year; by 1992 Q1 inflation had fallen to 0.8% i.e. 5.9 percentage points out of the 12.1 percentage points change in real M3 growth over the same period were due to lower inflation.

However, in order for the recovery to be durable, aggregate real incomes or real purchasing power must not be allowed to grow excessively. As of 1992 Q1 the year-on-year growth of real M3 was 8.7%. Given the capacity constraints of the New Zealand economy and its limited (but admittedly improved) growth potential it would probably be unwise to allow real M3 growth to stray into double digits for any sustained period of time. In this respect the implementation of the new Reserve Bank Act from 1st February 1990 represents a major step in the right direction. Section 8 of the Act spells out that "the primary function of the Bank is to formulate and implement monetary policy directed to the economic objective of achieving and maintaining stability in the general level of prices." There is no other goal specified. Economic growth, full employment or balance of payments equilibrium or other targets are notable by their absence. Section 9 of the Act gives the Minister of Finance power to appoint (and re-appoint) a Governor of the Reserve Bank, and to fix and review policy targets, but by implication those targets can only be inflation targets. Moreover, the accountability of the Governor and the transparency of the policy objectives are made much clearer by the requirement in Section 9 that the policy targets shall be published in the Gazette and a copy shall be laid before the House of Representatives. These objectives can only be overridden temporarily (for a period of 12 months) by an Order in Council, but again such an Order must be Gazetted and laid before the House.

As set out in the Chronology of Main Economic Reforms (pp. 36-39) the date for achieving the inflation target was adjusted in December 1990 so that the current target is the achievement of 0-2% inflation in 1993. In fact this goal has already been met in so far as the CPI for 1992 Q1 was 0.8% year-on-year, but it will require persistent restraint to ensure that monetary growth does not creep upward as credit demands expand in line with the recovery in the economy. In sum, the newly created framework for the Reserve Bank -- namely, (1) Reserve Bank independence, (2) accountability of the Governor to the Legislature, and (3) the exclusive focus on a single policy target (i.e. price stability) -- offers a reasonable prospect for the sober and stable conduct of monetary policy for the medium term future.

(ii) New Zealand's International Competitiveness

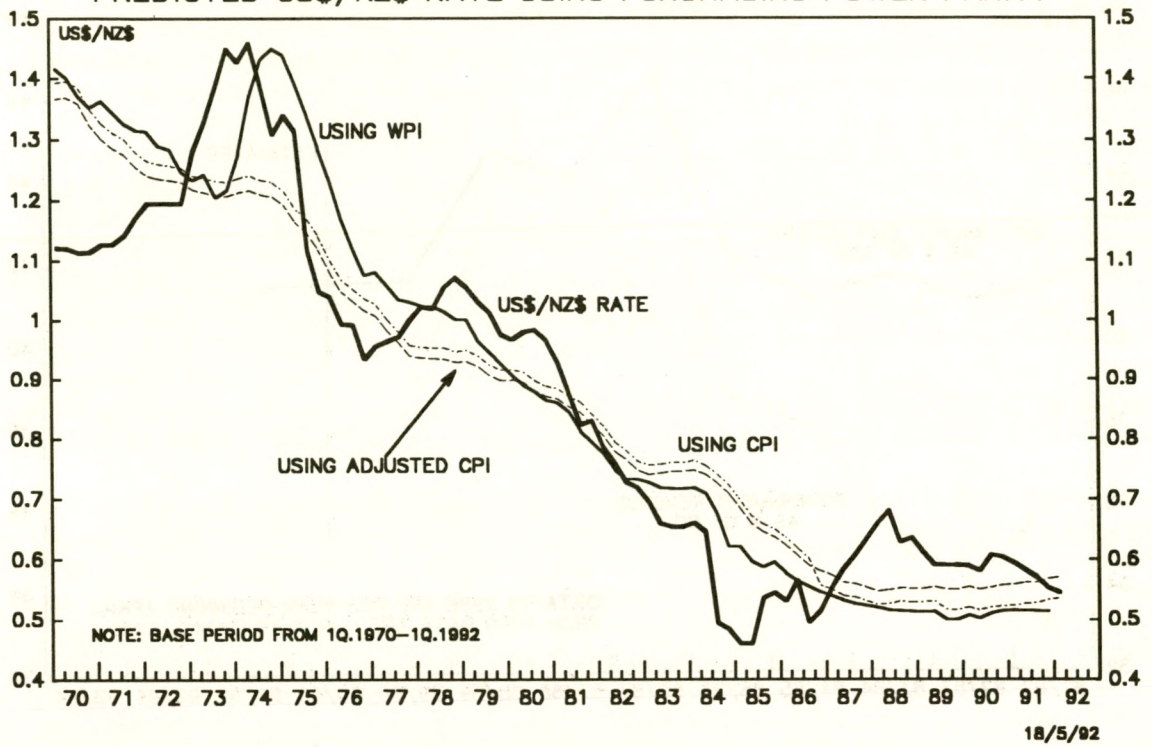
Turning to New Zeland's external competitiveness, this can be measured in two ways -- on a bilateral basis via purchasing power parity, or on a multi-lateral basis via a real effective exchange rate index. Chart 6 shows the US$/NZ$ exchange rate and different measures of equilibrium (or appropriate) exchange rates which would yield purchasing power parity for three sets of US and New Zealand price indices. As is clear from the chart the difference between these predicted PPP rates and the actual rate in 1992 Q1 was insignificant. In fact the actual rate was almost exactly halfway between the GST-adjusted CPI measure of PPP and the WPI measure of PPP. More importantly from the point of view of fostering economic recovery, the depreciation in the NZ dollar against the US dollar since the second quarter of 1988 has brought the New Zealand currency down from being roughly 25% "overvalued" to a position where it is now very fairly valued on a PPP basis. This will help New Zealand's agricultural and forest products sectors sell more abroad, as well as enabling New Zealand's small but growing manufacturing sector to regain market share abroad.

On a multi-lateral basis, too, the past few years of monetary restraint and cost control are starting to pay significant dividends. Chart 7 shows the real effective exchange rate for the New Zealand dollar against a basket of 8 other currencies of its major trading partners. Between the 1984 devaluation of the New Zealand dollar and mid-1988 the currency appreciated from an index level of 84 to 123, or 46.4%. Since May 1988 the currency has depreciated by approximately 22% against the US$ (69 cents to 54 cents) and the real effective exchange rate has depreciated about 21% (123 to 97), but since monetary growth has been kept under restraint and inflation has been reduced to the lowest level among OECD countries, this must be regarded as a real depreciation or a real gain in competitiveness. (This is in contrast to a nominal depreciation followed by inflation which erodes the competitiveness achieved by devaluation). In other words, the gain in New Zealand's competitiveness in the last four years would appear to be sustainable, and compatible with continued low inflation.

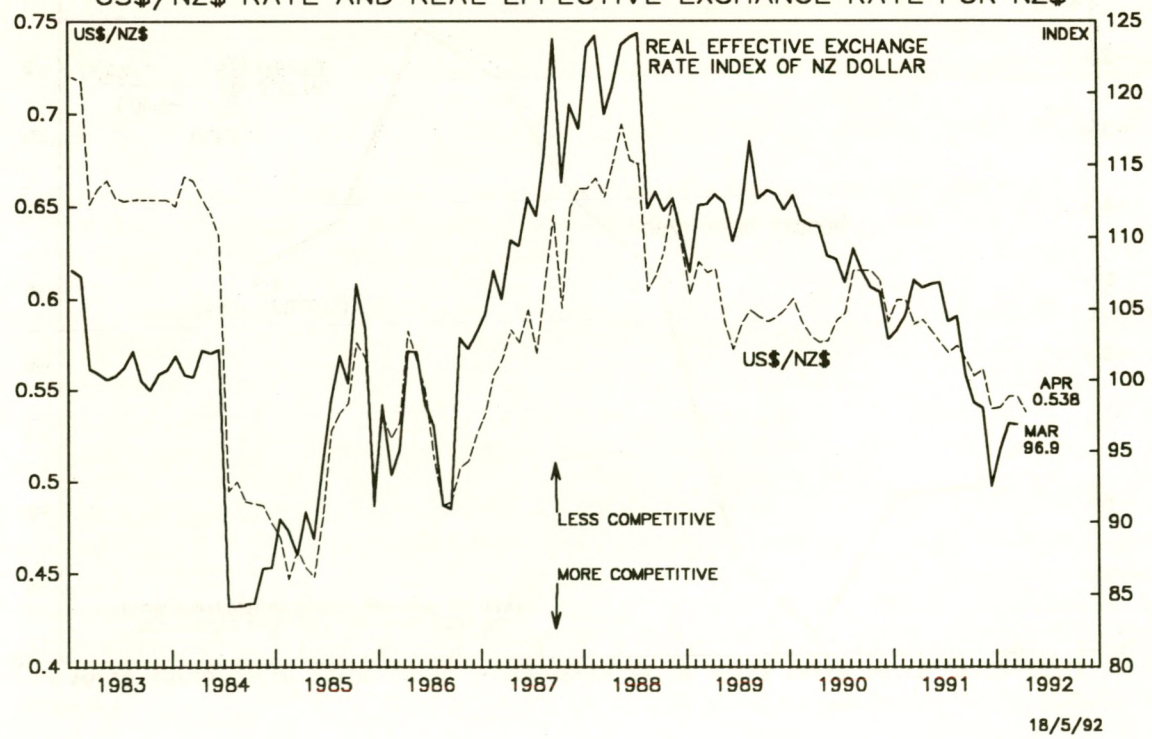
(iii) The Size and Role of Government in the Economy

Finally we consider the question of the potential for New Zealand's economic recovery in the face of continued high levels of government expenditure. Since the early days of reform under the Labour government this has been one of the major areas of disappointment to most observers of the great New Zealand experiment with reform. Between 1983 and 1986 government expenditure averaged just under 42% of GDP (Chart 8), and then with the imposition of GST (Goods and Services Tax) in October 1986 government revenues rose sharply, but so too did government expenditures. In 1987 government expenditures peaked at 47% of GDP. Since that time successive governments have struggled to close the gap between revenue and expenditure, seemingly without success (Chart 9). In fact, in the latest 3-year estimates released in April by Ruth Richardson the government's financial situation has deteriorated again, with tax revenues falling NZ$ 736 million below the figures estimated as recently as December. In part this was due to some erosion of the tax base, and in part due to lower yields from the company profits tax due to lower profits than anticipated. In addition, there had been some overstatement of tax collections in the July-December period. Non-tax revenues also fell NZ$ 102 million due to lower dividends (from the Reserve Bank and from Electricorp).

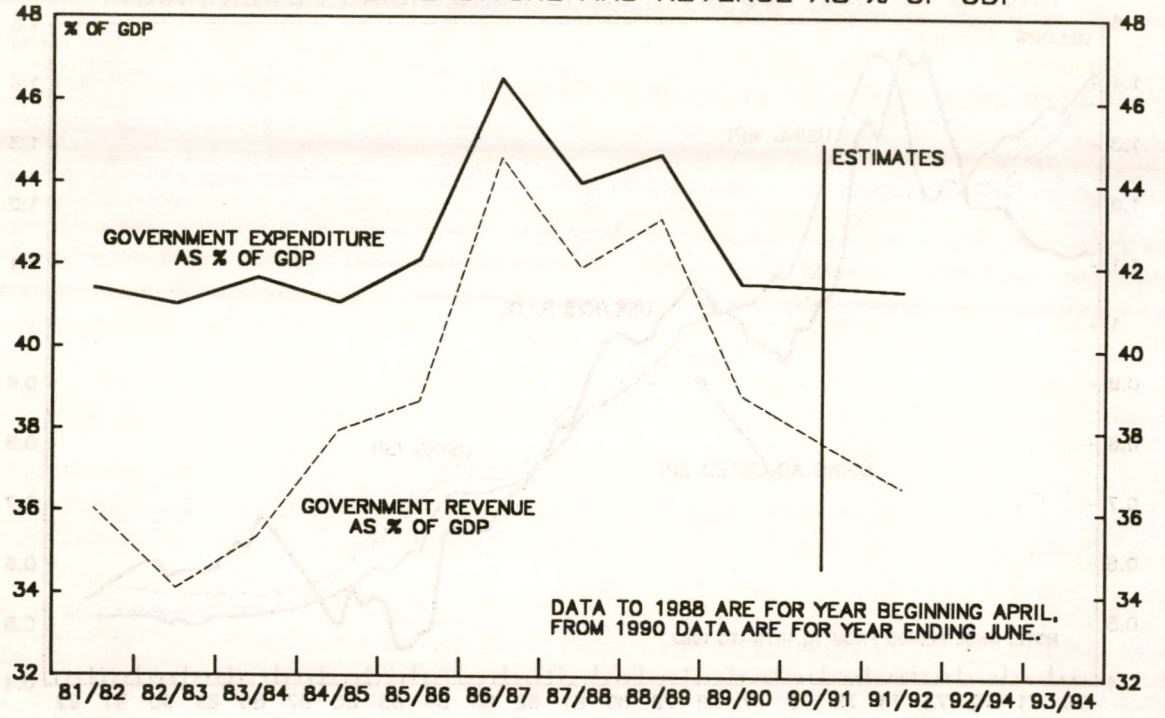
NEW ZEALAND: CHART 6
PREDICTED US$/NZ$ RATE USING PURCHASING POWER PARITY



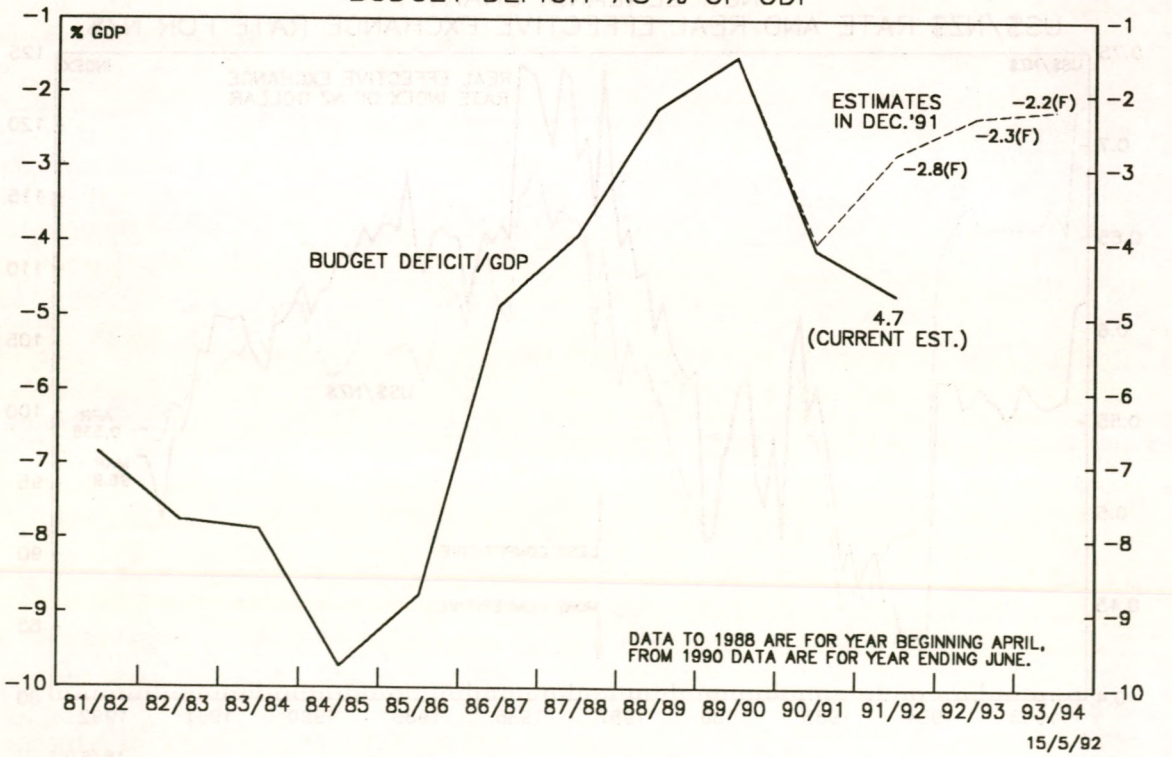
NEW ZEALAND: CHART 7
US$/NZ$ RATE AND REAL EFFECTIVE EXCHANGE RATE FOR NZ$



NEW ZEALAND: CHART 8
GOVERNMENT EXPENDITURE AND REVENUE AS % OF GDP



NEW ZEALAND: CHART 9
BUDGET DEFICIT AS % OF GDP



On the expenditure side, the 1991 Budget had planned for spending of NZ$ 29,790 million during the year ending June 1992. To their credit the authorities have held spending in check, so that the latest estimates (NZ$ 29,916 million) are only marginally higher than the original forecasts. However, this outcome is not quite as good as it seems. The original forecast included a provision for NZ$ 200 million for unforeseen expenses, most of which has been used up, and in addition debt servicing costs were down NZ$ 101 million on original estimates thanks to favourable interest rate and exchange rate movements. In short, only limited progress is being made in curbing current and capital expenditure, while revenue shortfalls are continuously adding to the funding burden. The ordinary fiscal deficit has thus expanded from a planned NZ$ 1,739 million to NZ$ 3,425 million, while the so-called Table 2 deficit which includes asset/liability transfers to and from the private sector has expanded from NZ$ 1,317 million to NZ$ 3,661 million. Together with some adverse timings of sale and purchase of assets plus similar effects from government borrowing and lending this has required an additional NZ$ 650 million in bond tenders and NZ$ 622 million in Treasury bill sales.

The standard fiscal deficit will thus amount to 4.7% of GDP in the financial year 1991/92 (Chart 9), or 5.1% of GDP if asset/liability transfers are included. On a cyclically adjusted basis the deficit may be somewhat smaller than these figures, but the overall result is still disappointing and shows how far New Zealand still has to go with the reform process to start to see progressive improvements in government revenue enabling the authorities to pay down debt either at home or abroad.

The fundamental problem is that with the government still taking and spending close to 42 cents out of every dollar of GDP generated, there is very little discretionary funding available for the private sector to invest in new areas of activity where New Zealand may prove to have a comparative advantage. Even in the case of Chile where tax rates and government spending were reduced to substantially lower percentages of GDP than in New Zealand (roughly 30% versus New Zealand's 42% or 43%), it took virtually a decade of adjustment following the radical reforms of the Pinochet years for entrepreneurs there to discover areas of activity where they could compete in the international arena. In the case of New Zealand this process of discovering where the country enjoys a comparative advantage could take even longer if such a large proportion of the private sector's income continues to be absorbed by government. The need for continued reform and a further reduction in government spending as a percentage of GDP is therefore still urgent.

FORECAST: During the past eight years New Zealand has undergone an extensive and painful process of economic reform involving deregulation, privatisation, elimination of protective tariff-walls and subsidies, extensive tax reform and a revision of the approach to managing public sector enterprises. However, government expenditure remains as high as 42% of GDP and is acting as a real millstone around the neck of the private sector as entrepreneurs struggle to create businesses which are going to be internationally competitive in the brave new world of a deregulated New Zealand economy. On the monetary front however, the basis is being laid for a moderate and sustainable receovery, while on the external front the combination of a sharp reduction in New Zealand's inflation rate plus a modest depreciation of the currency has done much to restore New Zealand's international competitiveness. In summary, the basis has been laid for a cyclical recovery, but the basis for a shift to a higher secular growth rate still awaits further reductions in government expenditure and a further unwinding of the welfare state.

CHRONOLOGY OF MAIN ECONOMIC REFORMS, 1984-1991*

July, 1984 Financial Market Reform.

* All interest rate controls were abolished. "Full funding" of fiscal expenditures adopted via domestic sales of government debt by open tender.

15th August 1984 Elimination of Export Incentives.

* Import Liberalisation Programme to reduce progressively quantitive import controls.

8th November 1984 Budget.

* A comprehensive goods and services tax (GST), accompanied by reform of existing indirect taxes and changes to the personal income tax and social welfare systems, to be introduced from 1 April 1986
* Various subsidies and incentives either removed completely or to be phased out over a period of years.
* Interest rates on government-funded rural lending to be progressively increased to market levels.
* Similarly, the price of state-supplied electricity and coal to be progressively increased to market levels reflecting the full cost of supply.

December 1984. Wages Freeze Abandoned.

* Start of first wage round since the wage freeze was imposed in June 1982.

6 December 1984 "Budget '85" Taskforce Announced.

* To increase public awareness, and to investigate options for reforms to the social welfare benefit and personal income tax systems.

December 1984 Foreign Exchange Controls Abolished.

* Only some reporting requirements were retained.

February 1985 Government Security Ratios Abolished.

* Ratio requirements which had applied to financial institutions and superannuation funds were abolished.

March 1985 Foreign Ownership Controls Lifted.

* Limits on foreign ownership fo New Zealand financial institutions abolished. Restrictions on foreign direct investment relaxed.

March 1985 Exchange Rate Floated.

13 June, 1985 Budget.

* Expenditure priorities across government departments to be more rigorously assessed.
* Charges for government-provided services increased to full cost recovery basis.
* Public sector efficiency to be improved by moving state-trading enterprises to a more commercial and competitive basis.

20 August, 1985 Shift to Indirect Taxation: Reform of Social Benefits.

* A comprehensive goods and services tax (GST) to be introduced from 1 October 1986 at a uniform 10 percent, together with cuts in personal income taxes (top personal tax rate to be cut from 66% to 48%.
* A full imputation system for taxation of distributed company income to be introduced from the 1988/89 financial year.

*** Sources: "Rogernomics" ed. Simon Walker; OECD Economic Surveys, New Zealand 1990/91; and CS First Boston Pacific.**

Chronology continued:

12 December 1985 Economic Statement

* Taxation changes and import tariff reductions.
* Reduction of tariff rates to zero on goods not made in New Zealand, unless trade policy obligations require otherwise.

December 1985 Labour Legislation.

* A limited degree of contestability introduced in the market for union representative rights.

19 May 1986 Government Expenditure Reform

* Statement on Government Expenditure Reform. The trading activities of the Electricity Division, State Coal Mines, Post Office and Civil Aviation to be changed from departmental organisations to corporate structures.

April 1987 Barriers to Entry in Banking Removed.

April 1987 Corporatisation.

* Nine new public sector corporations structured on commercial lines.

18 June 1987 Budget. Highlights include:

* The first forecast surplus (of $375 million) for 1987/88 in 35 years, in good part achieved by major asset sales and semi-government borrowings.

17 December 1987 Economic Statement.

* A reduction of tariffs on motor vehicles and components from 1 January 1989.
* Tariffs on goods not subject to industry plans (i.e. excluding footwear, carpets, apparel, and motor vehicles) to be reduced by half in five steps between 1 July 1988 and 1 July 1992.
* Goods subject to industry plans to become subject to the general tariff reduction programme on expiry of the plan.

Other measures include:

* Competition in the telecommunication industry.
* A review of local government structure.
* A review of professional and occupational group monopolies.
* All tax concessions for superannuation (pension) contributions and life insurance premia eliminated.

10 February 1988 Revised Economic Package.

* Business and Company Tax Reform. Company tax cut from 48% to 28% from 1st April 1988.
* Indirect Taxation. Full importation system to be introduced from 1st April 1988.
* Personal Tax. Top personal income tax rate cut from 48% to 33%.
* The scale of marginal personal tax rates to be 24 percent up to $30,875 per annum, and 33 percent above that level

March 1988 Labour Market Decentralisation.

* State Sector Bill provides for decentralised management, merit based appointments, performance related remuneration and departmental wage bargaining.

March 1988 Stamp Duty Abolished.

April 1988 Deregulation of Broadcasting Initiated.

May 1988 Deregulation of Petroleum Industy.

June 1988 Australasian Free Trade Area.

* Agreement to introduce free trade in goods and services with Australia by July 1990.

28 July 1988 Budget.

* Confirms the intention to introduce capital gains tax, to develop proposals for interest withholding tax and to extend this to domestic dividends while deferring the contractors' withholding tax.

Chronology continued:

4 November 1988 State-Owned Enterprises Minister Richard Prebble Dismissed from Cabinet.

* The dismissal takes place amid controversy with the Prime Minister over the handling of SOE asset sales.

14 December 1988 Finance Minister Roger Douglas departs from Cabinet.

* Douglas's departure occurs amid continuing controversy with the Prime Minister over the handling of economic policy.

21 March 1989 Tax Increase.

* An increase in the GST rate from 10 per cent to 12.5 per cent effective from 1st July 1989.
* An increase in the company tax rate, from 28 per cent to 33 per cent, from 1st April 1989.

18 April 1989 New Zealand-Australia Trade Policy.

* The removal of manufacturing trade barriers between New Zealand and Australia from July 1989, one year earlier than planned.

4 May 1989 Reserve Bank Independence.

* The Reserve Bank of New Zealand Bill was introduced into Parliament. The Bill would place the Reserve Bank of New Zealand on a more independent but more accountable legislative basis than had been the case.

27 July 1989 Budget.

18 August 1989 Privatisation.

* The sale of the Rural Banking and Finance Corporation to Fletcher Challenge for $ 550 million was announced.

3 October 1989 DFC Collapse

* The Governor of the Reserve Bank of New Zealand announced that statutory managers had been appointed to DFC New Zealand Limited.

12 December 1989 Privatisation.

* The sale of the Government Printing Office to Rank Group fo $ 23 million was announced.

15 December 1989 Reserve Bank Act.

* The Reserve Bank of New Zealand Act was passed in Parliament with the new legislation to become effective from 1st February 1990. The intial policy target was set at 0-2% (year-on-year) CPI inflation by 1992.

1 January 1990 Free Trade in Motor Vehicles (under CER).

* Agreement with Australia to end all restrictions on trans-Tasman trade in motor vehicles.

20 March 1990 Economic Statement

The major points were:

* The removal of the restrictions on ownership of ports.
* A proposed restructuring of New Zealand Railways with a view to corporatisation.
* A programme of tariff reduction from 1992 to 1996.
* A proposed Labour Relations Act enabling more flexible work practices. Employers with more than 50 employees allowed to initiate enterprise bargaining through a workers' ballot.
* The intention to sell Telecom.

3 May 1990 Privatisation.

* The sale of the State Insurance Office to Norwich Insurance for $ 735 million was announced.

Chronology continued:

14 June 1990 Privatisation.

* The sale of Telecom to a consortium comprising two American companies and two New Zealand companies, for $ 4,250 million was announced.

15 June 1990 Privatisation.

* The sale of the Tourist Hotel Corporation of New Zealand was announed.

24 July 1990 Budget. Highlights:

* The planned redemption of $5 billion of public debt over the 1990/91.
* The abolition of excise duties on diesel fuel and on motor vehicles.

17 September 1990 Trade Unions.

* The Government and the Council of Trade Unions signed a Growth Agreement.

29 October 1990 General Election.

* The National Party wins the general elections.

December 1990 Reserve Bank Inflation Target.

* The target date for achieving price stability (0-2% year-on-year for the CPI) was extended to 1993.

December 1990 Welfare Reforms.

* The new National government announced wide ranging reforms of the welfare system, reducing benefit rates, tightening up eligibility criteria and income testing.

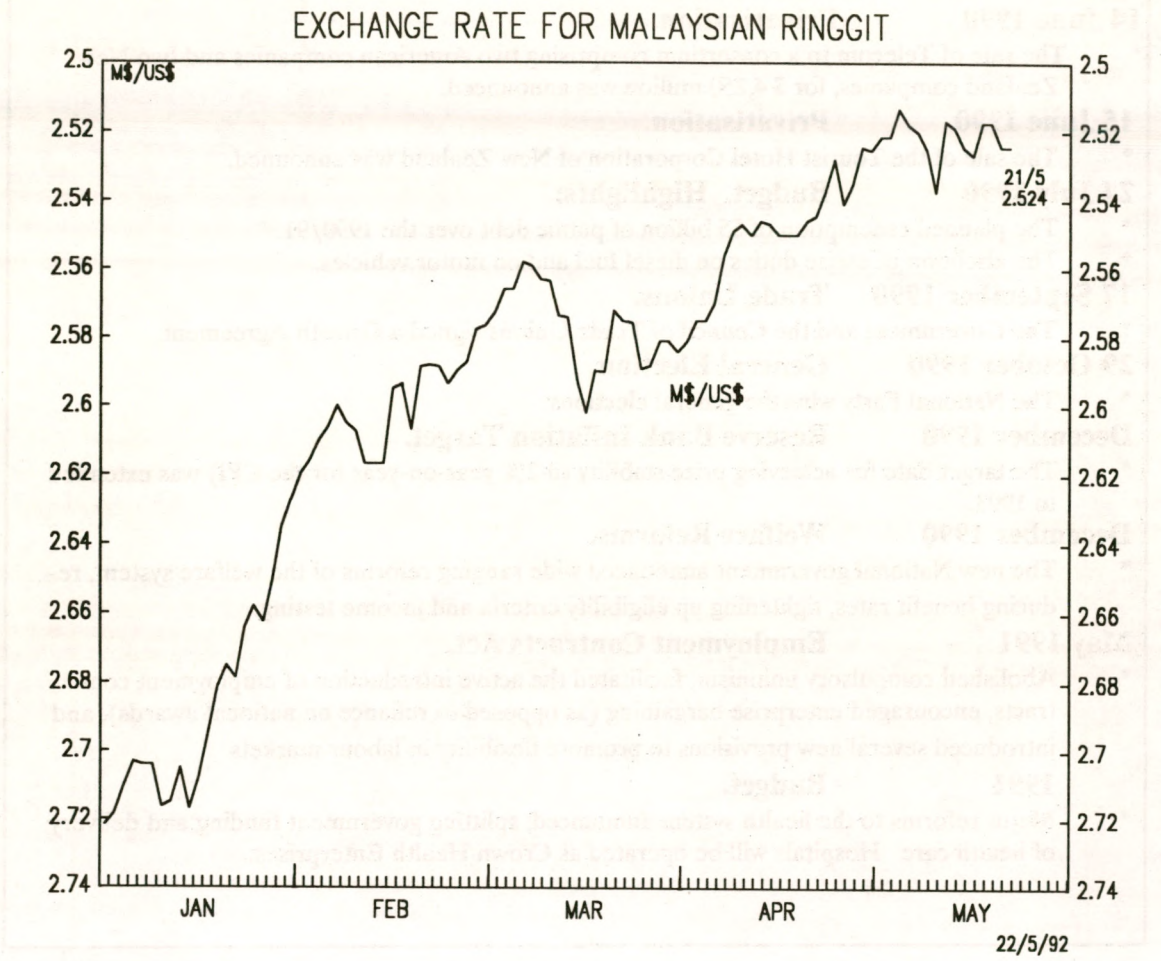
May 1991 Employment Contracts Act.

* Abolished compulsory unionism, facilitated the active introduction of employment contracts, encouraged enterprise bargaining (as opposed to reliance on national awards), and introduced several new provisions to promote flexibility in labour markets.

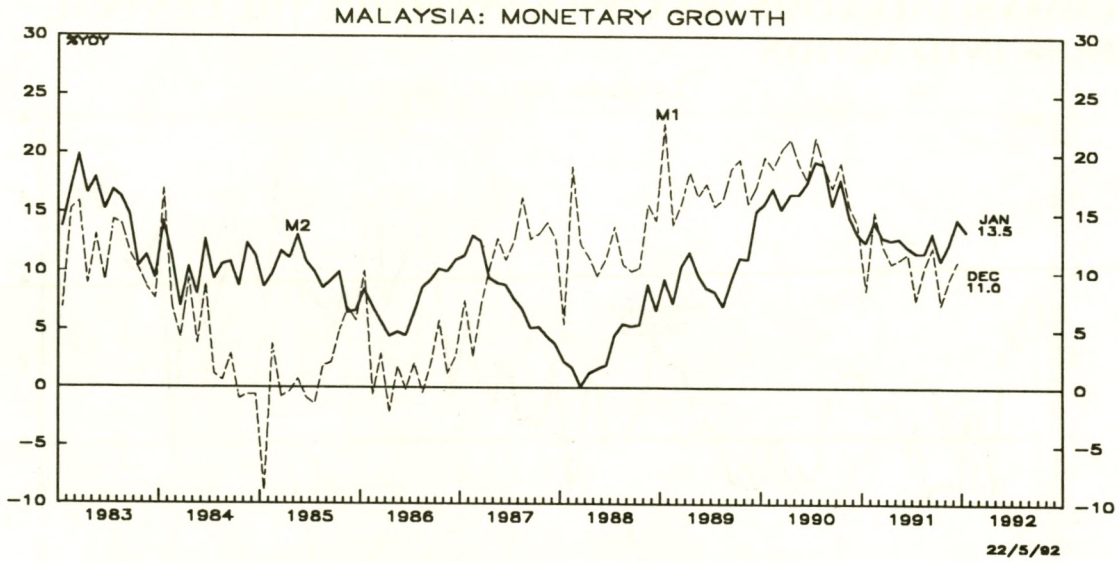
1991 Budget.

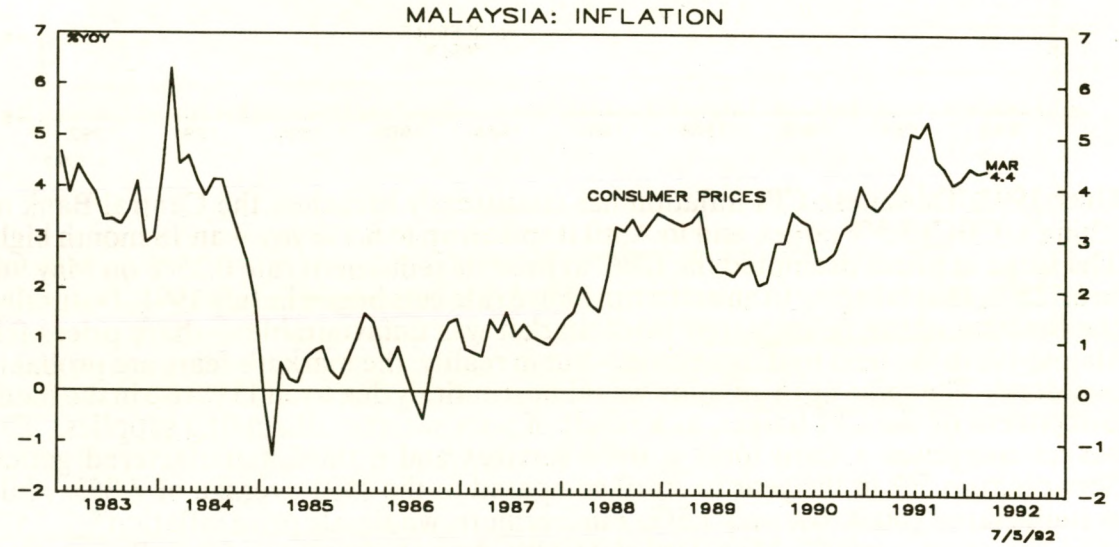
* Major reforms to the health system announced, splitting government funding and delivery of health care. Hospitals will be operated as Crown Health Enterprises.

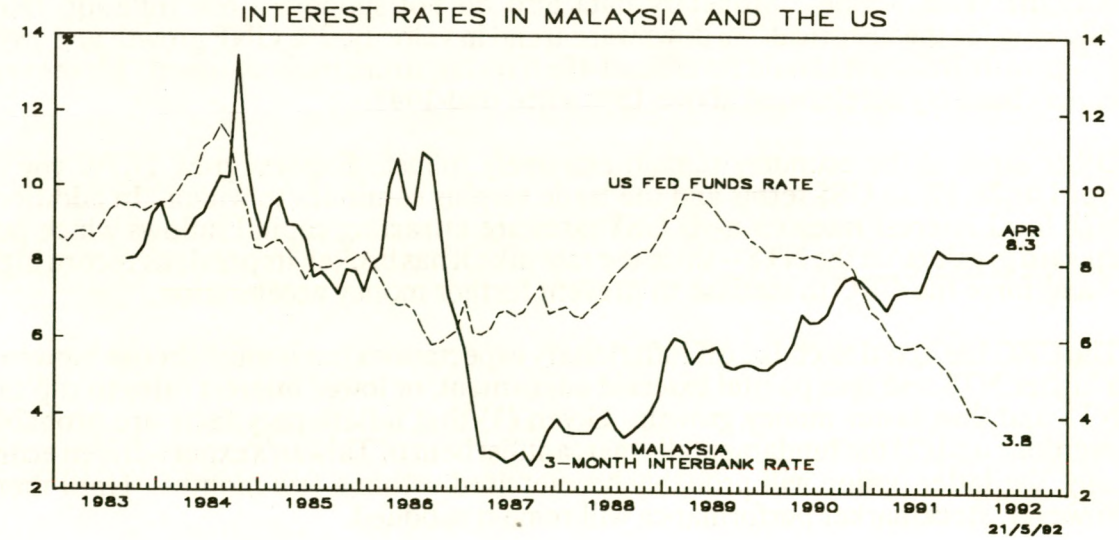
MALAYSIA: TIGHTER MONETARY POLICY



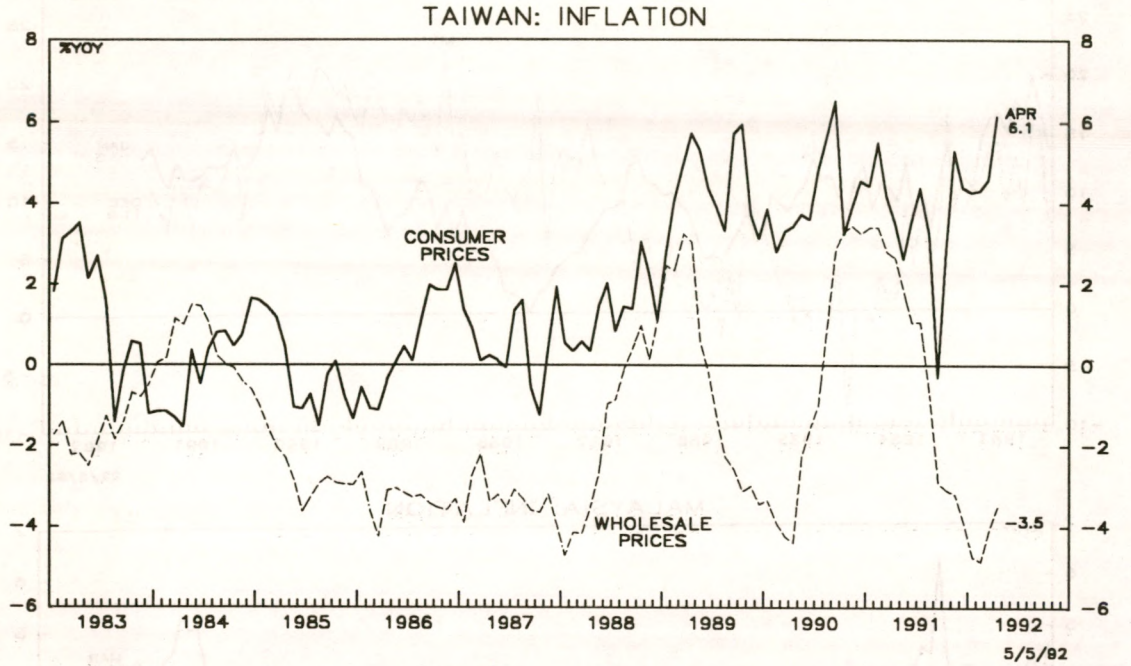
The decision by the Malaysian authorities in January 1992 to let the ringgit appreciate against the US dollar allowed them a greater degree of freedom in their interest rate policy (see AMM Vol. 16 No. 2). The ringgit has remained in its upward path against the US dollar ever since (chart above). This reinforces the position of the central bank that the days of "cheap ringgit" are now over. Money stock growth remains on a downward trend and this is likely to be maintained (top chart opposite) given an increase in bank reserve requirements effective as from May 1992. Inflation is also likely to be trending down (middle chart opposite). The authorities will not be in a hurry to ease interest rates unless they are satisfied that inflation is subsiding and liquidity is under control. The continuing appreciation of the ringgit and the relative firmness of interbank rates (bottom chart opposite) indicate that the authorities are not capping the rise of their currency against the US dollar. This counterinflationary stance, if maintained over the next months, will augur well for the prospects of lower interest rates towards the end of the year or equivalently for the authorities capping the appreciation of the ringgit. It must be remembered that the Malaysian economy is expected to grow at nearly 8% during 1992 and hence inflationary pressures remain quite strong.


MALAYSIA: MONETARY GROWTH
%YOY
M1
M2
JAN
13.5
DEC
11.0
22/5/92


MALAYSIA: INFLATION
%YOY
CONSUMER PRICES
MAR
4.4
7/5/92


INTEREST RATES IN MALAYSIA AND THE US
%
US FED FUNDS RATE
APR
8.3
3.8
MALAYSIA
3-MONTH INTERBANK RATE
21/5/92

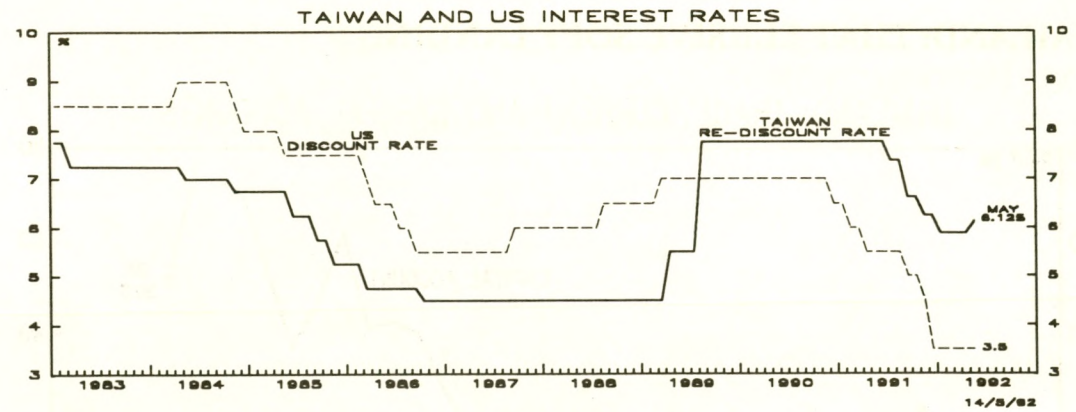
TAIWAN: INFLATIONARY CONCERNS FORCE THE CENTRAL BANK INTO ACTION

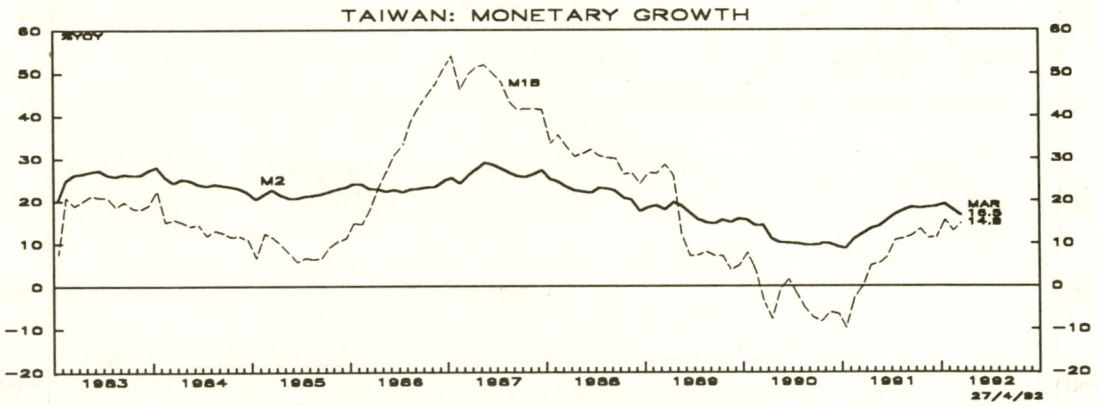


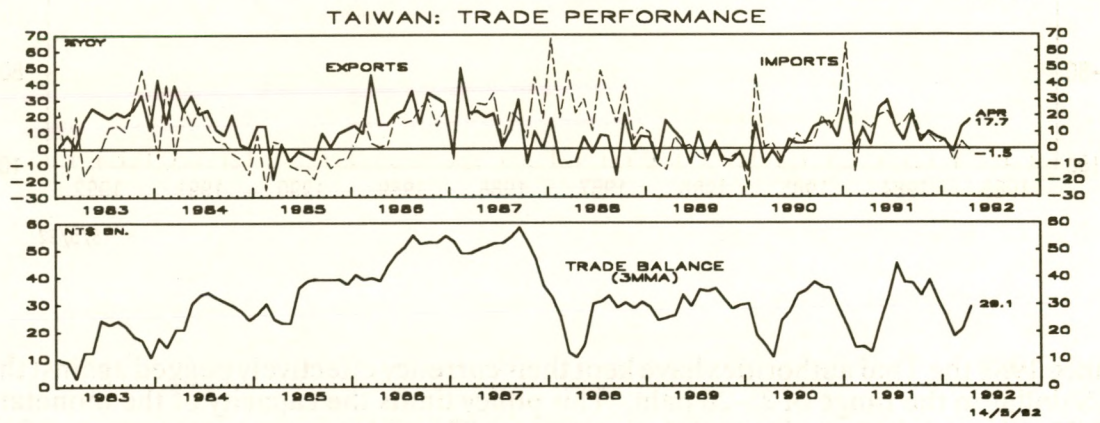
Over 1992, Taiwanese CPI inflation has consistently breached the Central Bank of China's (CBC) 3.5% target, and in April it spiked up to 6.1% yoy -- an 18 month high. The surge in prices prompted the CBC to raise its rediscount rate 0.25% on May 9th to 6.125%, thus bringing to an end a run of five rate cuts begun in July 1991. Naturally, the reaction of the beleaguered stock market was unfavourable -- share prices fell almost 4% in the next trading session -- but in reality, the market's fears are probably overdone. The spike up in inflation was almost entirely due to an 11% rise in the foods component of the CPI basket, as a result of poor weather disrupting supplies. The basket comprises a third food, a third services and a third manufactured goods. Services rose 5% in the year to April compared to the 1991 average of 7-8%, while manufactured goods rose only 1.5%. Furthermore, wholesale price inflation fell 3.5% over the same period. Monetary data also do not support a 6% inflation rate. Allowing for the historical 7% downward trend in velocity, 7% GNP growth and 18% M2 growth, inflation should be around 4% if no lag structure is assumed. Moreover, money has only accelerated above 15% since mid-1991.

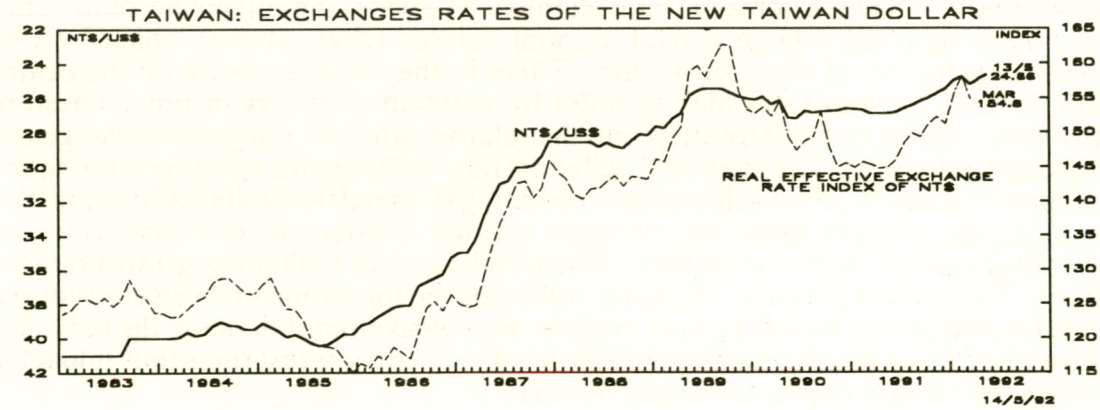
Other areas of the economy remain extremely robust. Exports grew 17.7% yoy in April or 28.8% in US$ terms and the trade surplus continues to widen. In addition, high local interest rates vis-a-vis US$ rates are attracting capital inflows which put upward pressure on the NT$ -- since the rate hike it has broken its previous record high -- and force the CBC to sterilise to prevent further money acceleration.

The CBC has acted to choke off inflationary expectations but it must choose between a higher NT$ and thus painful external adjustment, or lower interest rates to cap the NT$ and thus faster money growth. Given (1) that inflationary fears are probably overdone and (2) the fundamentally mercantilist bent of Taiwan's export-driven economy, the latter option will probably be exercised within a few months. Until then, however, stockmarket performance will remain subdued.

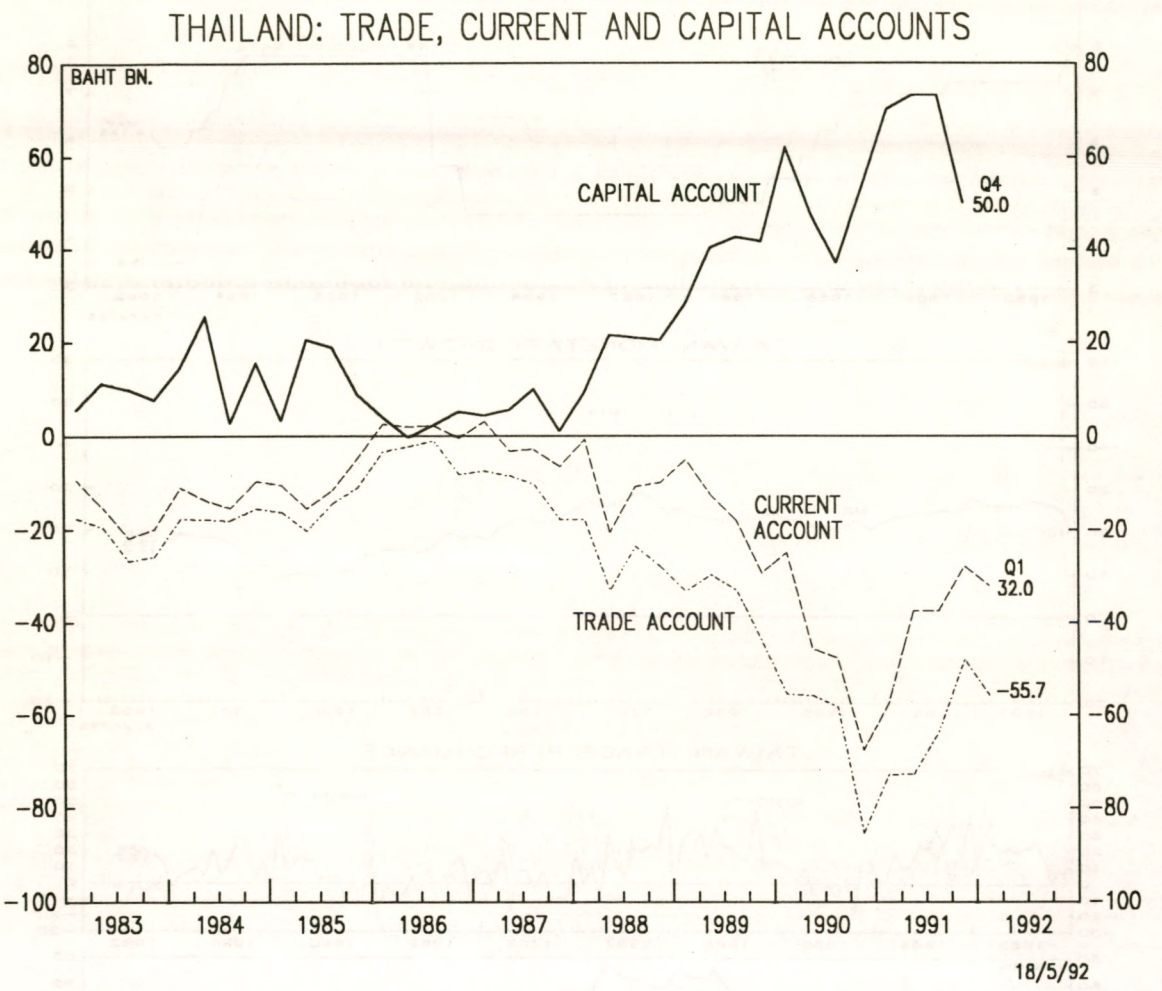

TAIWAN AND US INTEREST RATES
%
US DISCOUNT RATE
TAIWAN RE-DISCOUNT RATE
MAY 6.125
3.5
14/5/92


TAIWAN: MONETARY GROWTH
%YOY
M1B
M2
MAR 19.5 14.8
27/4/92


TAIWAN: TRADE PERFORMANCE
%YOY
EXPORTS
IMPORTS
APR 17.7
-1.5
NT$ BN.
TRADE BALANCE (3MMA)
29.1
14/5/92

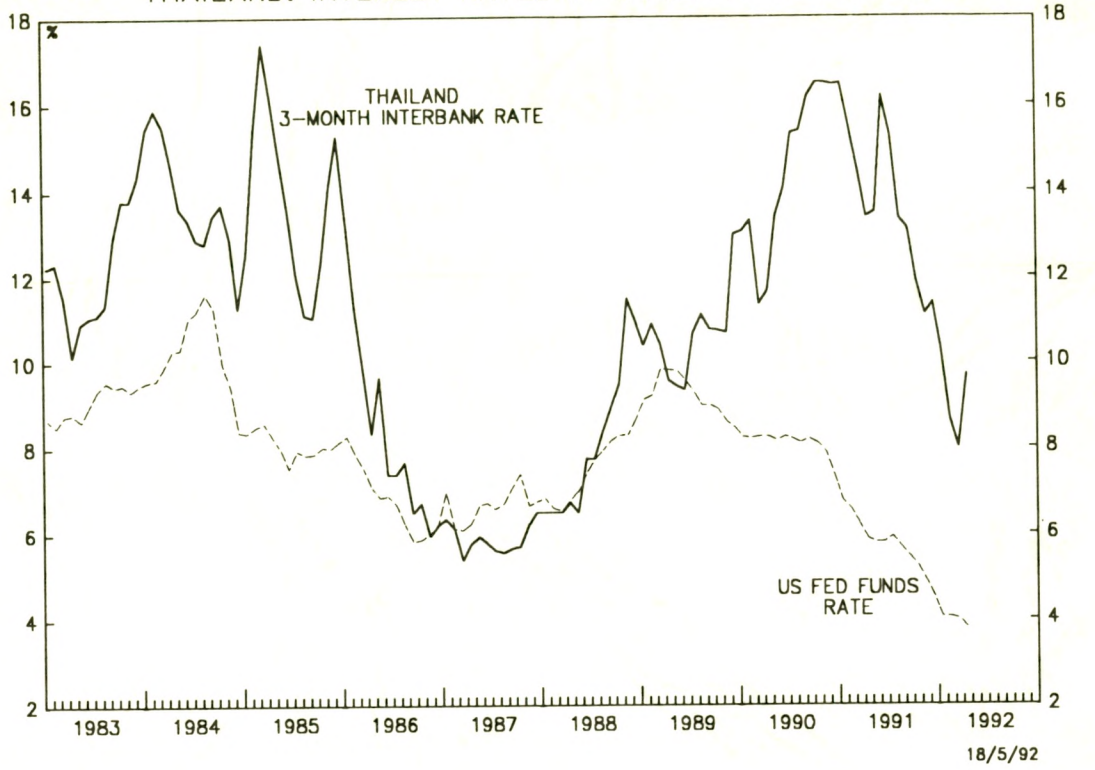

TAIWAN: EXCHANGES RATES OF THE NEW TAIWAN DOLLAR
NT$/US$
INDEX
13/5 24.66
MAR 154.8
NT$/US$
REAL EFFECTIVE EXCHANGE RATE INDEX OF NT$
14/5/92

THAILAND: THAT ELUSIVE SOFT LANDING

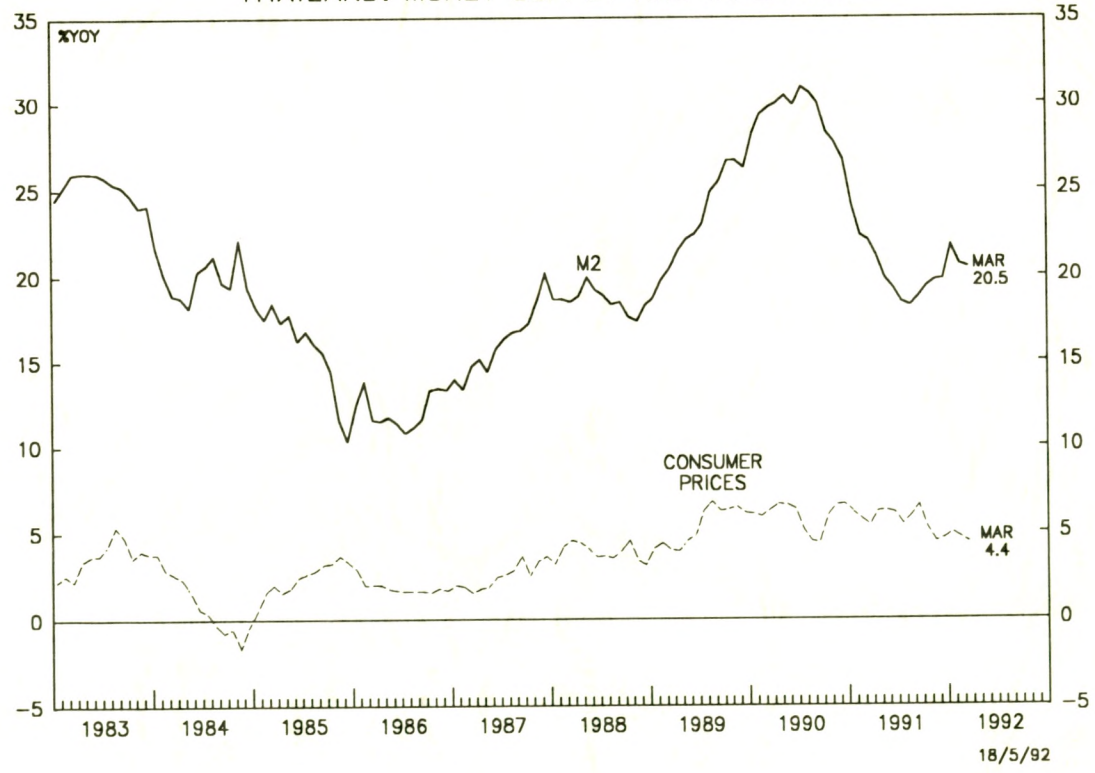


Since 1988 the Thai authorities have kept their currency effectively pegged against the US dollar in the range of 25-26 baht. This policy limits the capacity of the monetary authorities to influence domestic interest rates. The widening current account deficit since 1989 signified a large capital account surplus (chart above) which by 1991 consisted primarily of short term loans. There is, therefore, pressure on the central bank to keep interest rates high in order to maintain an inflow of funds based on attractive interest rate differentials and the relative safety of a pegged exchange rate (top chart, opposite). The Bank of Thailand is now walking on a tightrope hoping that the current account deficit will improve, obviating the need for capital inflows and thus justifying the policy of lower interest rates in order to boost the economy which has now slowed down. Inflation appears to be trending down but money growth remains strong. The current political instability, following the formation of an elected government headed by an unelected prime minister, may weaken confidence in the baht. The outcome of these developments could force a U-turn on interest rates thus impacting further the already depressed equity market.

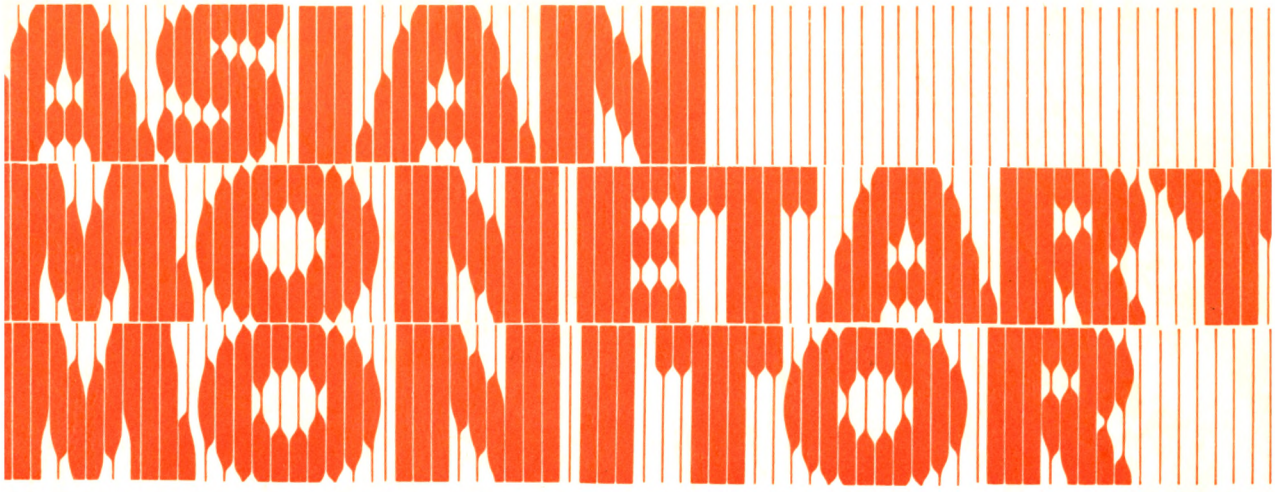
THAILAND: INTEREST RATES IN THAILAND VS THE US



THAILAND: MONEY SUPPLY AND INFLATION



AMM July-August 1992 Vol. 16 No.4



CONTENTS

		Page
REGIONAL SURVEY		
Asian Currency Valuations by Simon Ogus		1
HONG KONG		
Recent Trends in Currency Substitution by Y.C. Jao		12
PHILIPPINES		
Groping in the Dark for an Economic Miracle by Simon Ogus		22
BOOK REVIEW		
"Economics for Professional Investors"	SLO	33
ECONOMIC CAPSULES		
Indonesia: A Looser Monetary Policy but the Banks Refuse to Lend	SLO	34
Japan: Preconditions for an Economic Recovery	JGG	36
South Korea: No Signs of Relaxation in Monetary Policy	AFF	38

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ASIAN MONETARY MONITOR

July-August 1992 Vol. 16 No.4

REGIONAL SURVEY
ASIAN CURRENCY VALUATIONS

The following article does not set out to provide a detailed, theoretical study of what determines long run real exchange rates. This area has been subject to numerous studies in the past and has yet to produce any real consensus. Rather this article restricts itself to updating and refining our own measures of Purchasing Power Parity (PPP) predicted exchange rates, and Real Effective Exchange Rates (REERs).

The basic theory of PPP states that in the long run, the equilibrium value of the nominal exchange rate between the currencies of two countries, will equal the ratio of the countries' price levels. Thus, a deviation of the nominal exchange rate from its PPP can be viewed as a measure of a currency's over/undervaluation. This argument is persuasive because it makes sense that the exchange rate adjusted price of identical goods should be the same in different countries. However, PPP fails to allow for various factors such as imperfect information, distribution costs, etc. which can lead to different prices in different locations. Furthermore, PPP does not generally employ the price of a single good -- such as the Economist's "Big Mac Index" -- but the price of a basket of goods, such as the consumer price index (CPI) or the wholesale price index (WPI). Clearly no two CPI/WPI baskets are identical. Moreover, even if one were able to construct identical price indices for different countries, PPP fails to offer any explanation of why differences between nominal and PPP exchange rates persist for long periods, or when the two exchange rates are supposed to converge. Finally, the choice of base date is crucial in PPP valuations as the (heroic) assumption is made that the nominal exchange rate is "fairly valued" at the series starting point. An informed estimate of "fair valuation" can be made by examining relative inflation rates, balance of payments positions, etc., but the final choice of base date will always involve a certain degree of subjectivity. We have therefore tried to get round this problem by calculating PPP valuations over a "long" time period -- generally 1970 onwards, but later if the price index used is not available from this date -- and then using the average PPP exchange rate over the whole period as the base value. Again this method is far from perfect, but at least it removes some of the subjectivity.

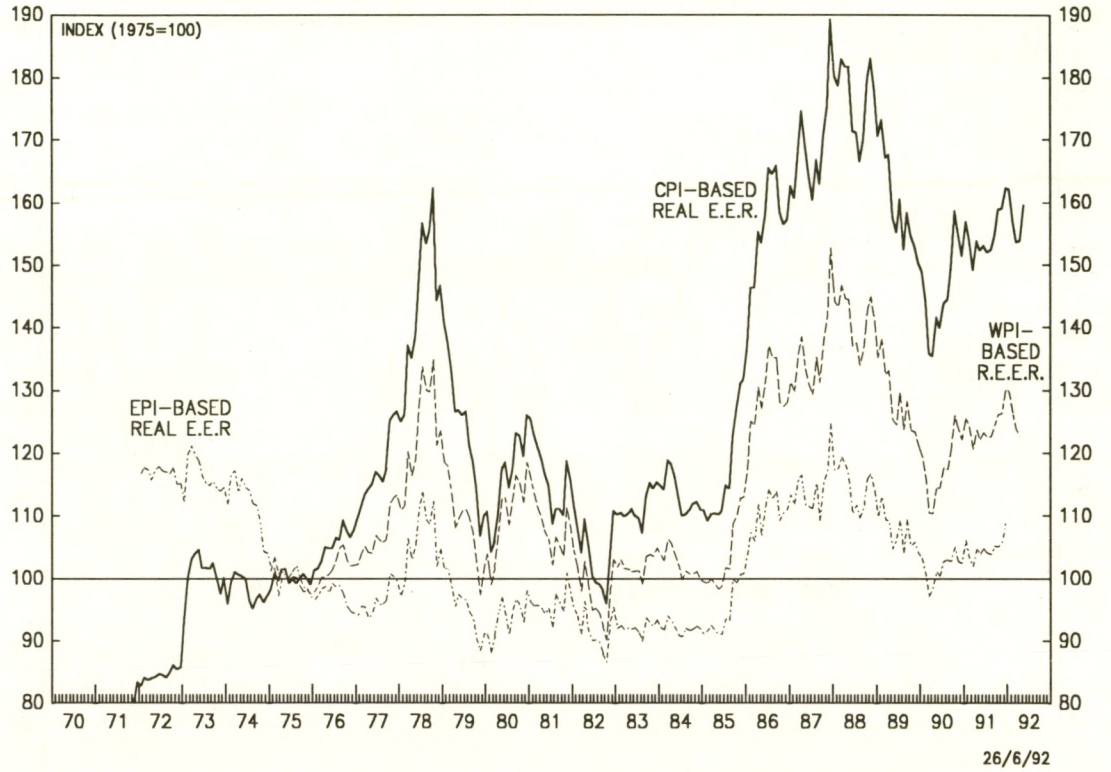
These reservations aside, PPP does offer a simple indicator of the extent of a currency's over/undervaluation, and in the absence of any superior measure, it continues to be widely used. However, caution needs to be exercised when interpreting any findings.

The various charts accompanying this article illustrate our US dollar PPP valuations against currencies of Japan and the 8 east Asian economies of the NICs and ASEAN. Also included are charts of REERs. A REER is a trade-weighted index of a number of bilateral PPPs. Our own measures employ the PPP exchange rates against an economy's 8 major trading partners in terms of value of exports in 1990. Every PPP and REER has been calculated (not all are charted) using three different price indices -- CPI, WPI and an export price index (EPI). However, before summarising the findings, it is necessary to make a few comments on the advantages and disadvantages of each of these baskets.

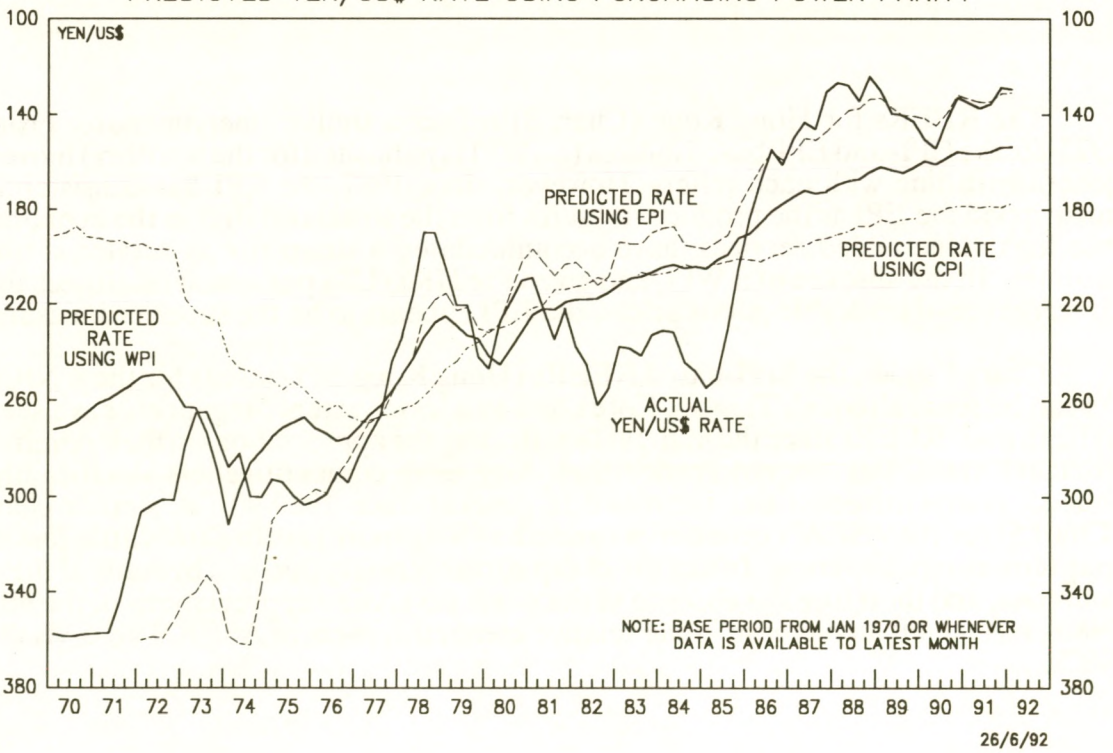
The CPI is the widest basket but as such it tends to contain the prices of more services and other non-tradeables. This makes direct comparisons more difficult. Using the WPI tends to strip out the prices of services, but WPIs tend to be more volatile -- at least on a month-to-month basis. Nevertheless, this volatility is diminished over longer periods of time as seasonal factors and other distortions drop out of the figures, and underlying WPI increases become more evident. Finally, the EPI reflects the prices of tradeables only, and tends to be less volatile than the WPI as exporters adjust their prices infrequently to minimise customer uncertainty. However, the EPI suffers the most in a developing economy from structural shifts in the composition of exports. In a develped economy, the EPI is probably the superior measure, but for countries such as Malaysia, Thailand and Indonesia which have shifted over the 1980s from a commodity to a manufacturing base, this measure is far from satisfactory. Conversely, a developed country's PPP will probably be most distorted by the use of the CPI which has a higher share of service and non-tradeable prices. The conclusion is, therefore, that over the period surveyed the WPI is the most appropriate index to use (if available) in the majority of cases. Only Japan has had a stable enough structure of exports to warrant the use of the EPI.

Charts 1 and 2 show the REERs and PPPs for Japan based on the CPI, WPI and EPI. As can be seen, the use of the CPI yields a very overvalued Yen both on a REER basis -- a 55% loss of competitiveness since 1970 -- and a PPP basis -- a Yen/US$ rate of 180 as opposed to 125-130. This proposition seems highly unlikely given the continued strength of the Japanese external accounts. However, the "overvaluation" is probably a consequence of the nominal exchange rate appreciation in the early 1970s (following the depegging of the Yen from the US dollar in August 1971), despite the fact that Japanese consumer prices were still rising around twice as fast as US consumer prices. Nevertheless, over the same period, Japanese productivity was also outstripping US productivity, and therefore service sector incomes in Japan were able to increase without Japan as a whole losing competitiveness. The rise in the CPI reflected this increase in service sector incomes. WPI and EPI valuations appear to support this argument yielding an overvalued (but less overvalued than using the CPI) and fairly valued PPP respectively, and REERs that suggest little change in competitiveness.

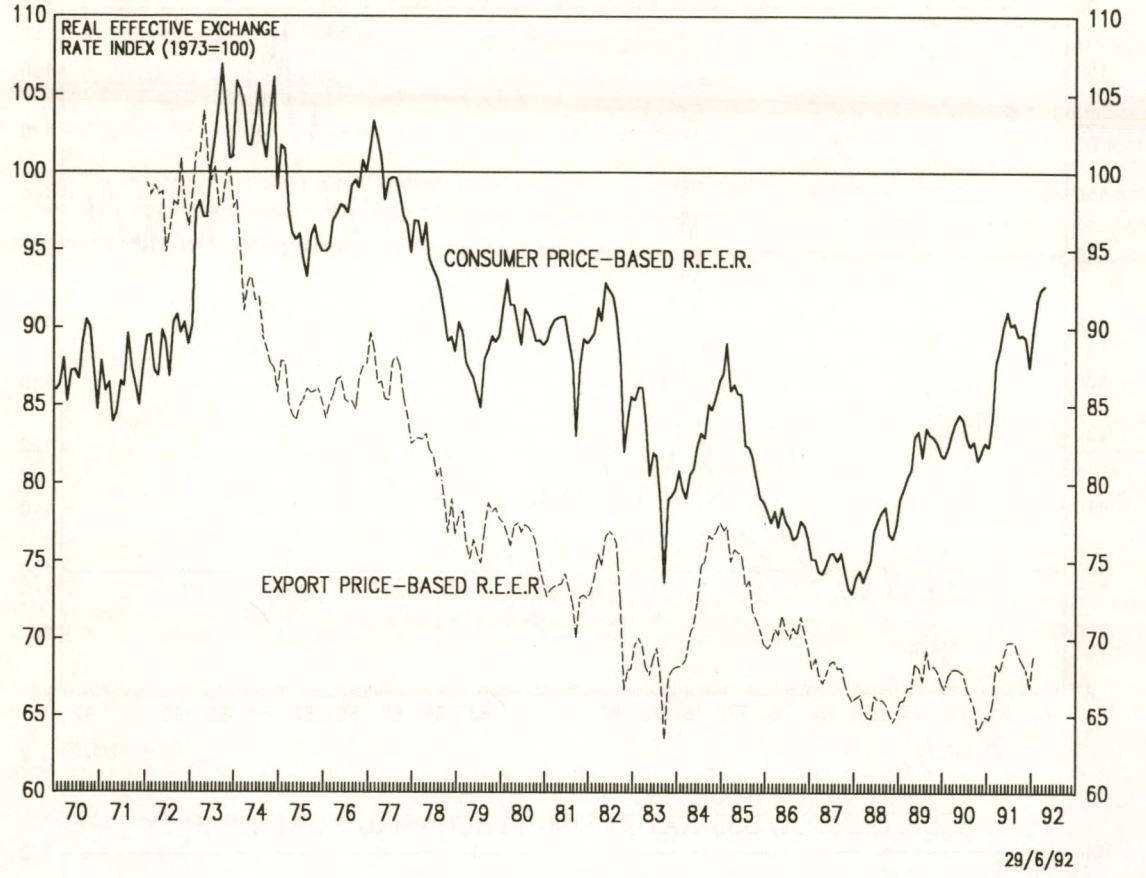
REGIONAL SURVEY: CHART 1
REAL EFFECTIVE EXCHANGE RATE INDICES OF THE YEN



REGIONAL SURVEY: CHART 2
PREDICTED YEN/US$ RATE USING PURCHASING POWER PARITY



REGIONAL SURVEY: CHART 3
REAL EFFECTIVE EXCHANGE RATE FOR THE HONG KONG DOLLAR

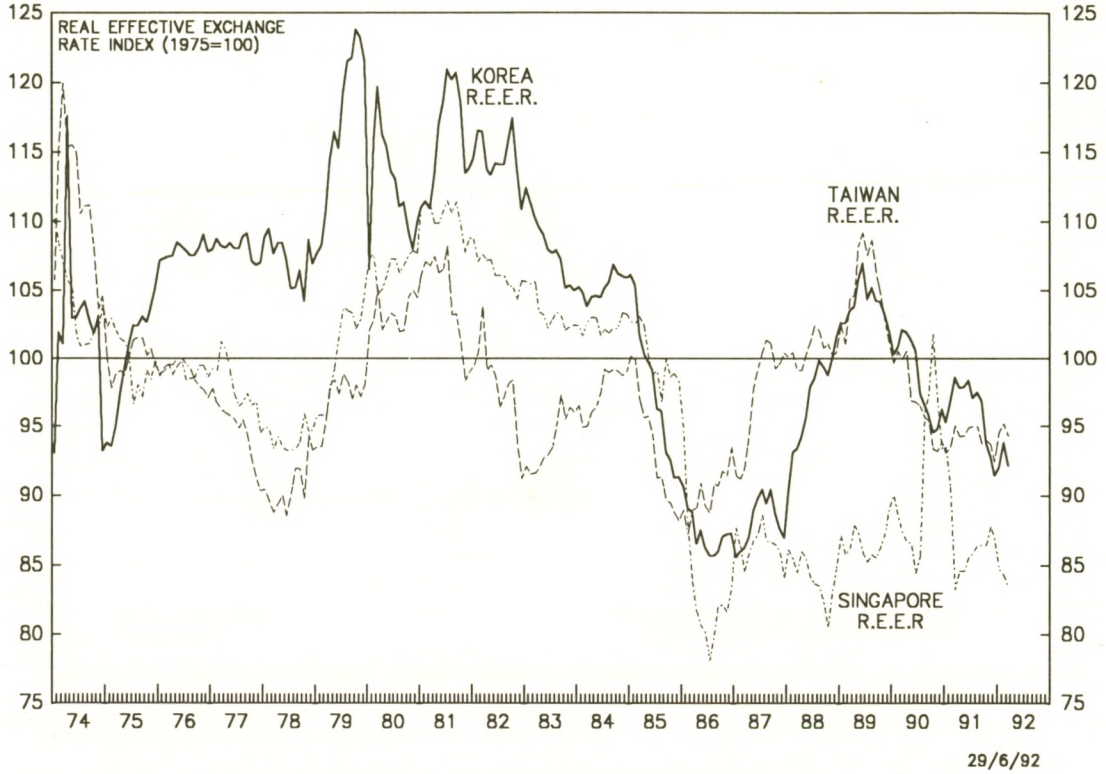


The REERs for Hong Kong (Chart 3) reflect a simliar phenomenon. From 1973-86, the CPI- and EPI-based indices (no WPI is published for the territory) moved generally in line with each other. However, since 1987, the CPI has consistently outstripped the EPI as the productivity gains from the structural shift in the economy into high value-added services, have accommodated a sharp rise in service sector incomes. In the absence of a WPI, and given the HK$/US$ peg which reinforces the convergence of tradeable goods prices, the EPI appears to be the superior measure.

Chart 4 shows the WPI-based REERs (Hong Kong EPI-based) for the 4 NICs. As can be seen, although Taiwan, Korea and to a lesser extent Singapore, have seen a rise in their REERs since the mid-1980s reflecting the appreciations in their nominal exchange rates, this has not eroded their long term competitiveness significantly. Indeed, competitiveness has improved in general since 1989-90. A similar chart (Chart 5) for the ASEAN economies (excluding Singapore) again shows little loss of long term competitiveness. In fact the cheap currency policy pursued by many of these countries, and therefore the absence of the north east Asian appreciations of the mid 1980s, has meant an increase in the relative competitiveness of ASEAN vis-a-vis the NICs.

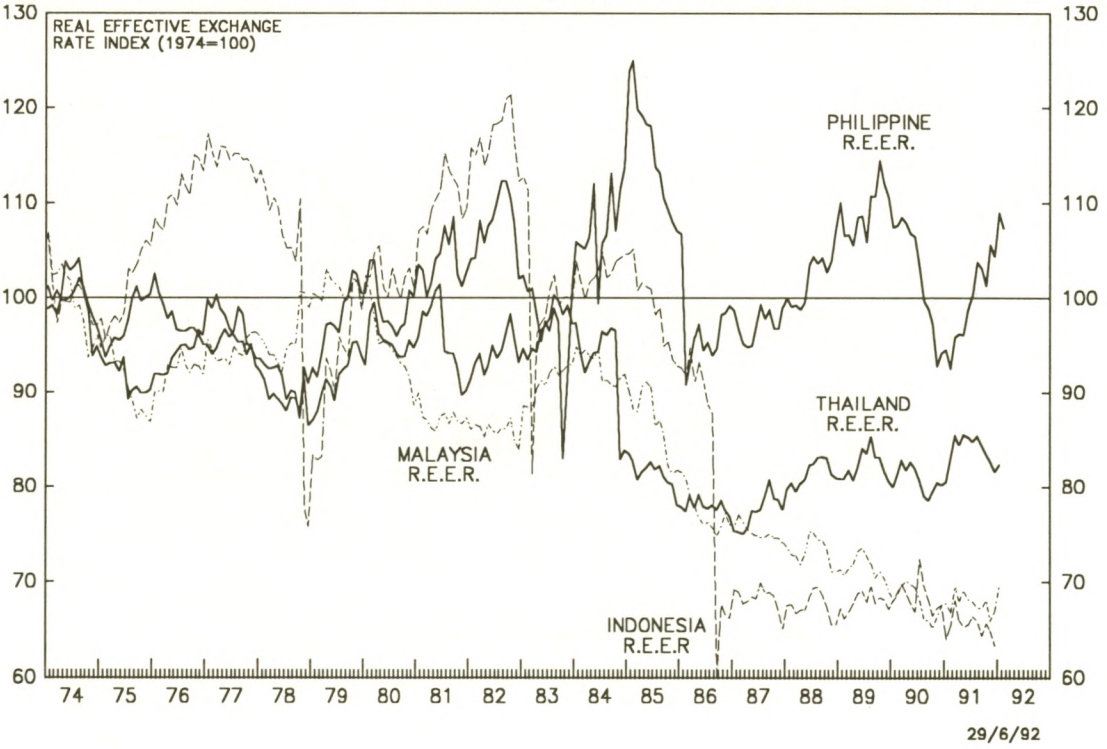
REGIONAL SURVEY: CHART 4

REAL EFFECTIVE EXCHANGE RATES FOR KOREA, SINGAPORE AND TAIWAN

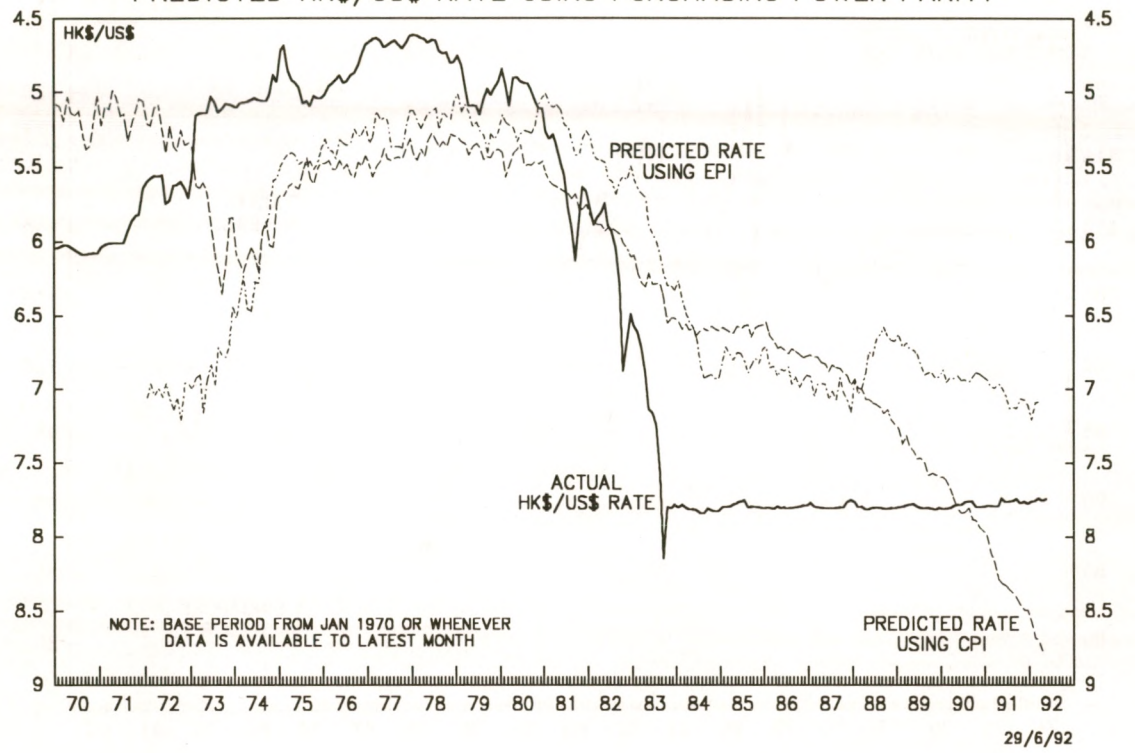


REGIONAL SURVEY: CHART 5

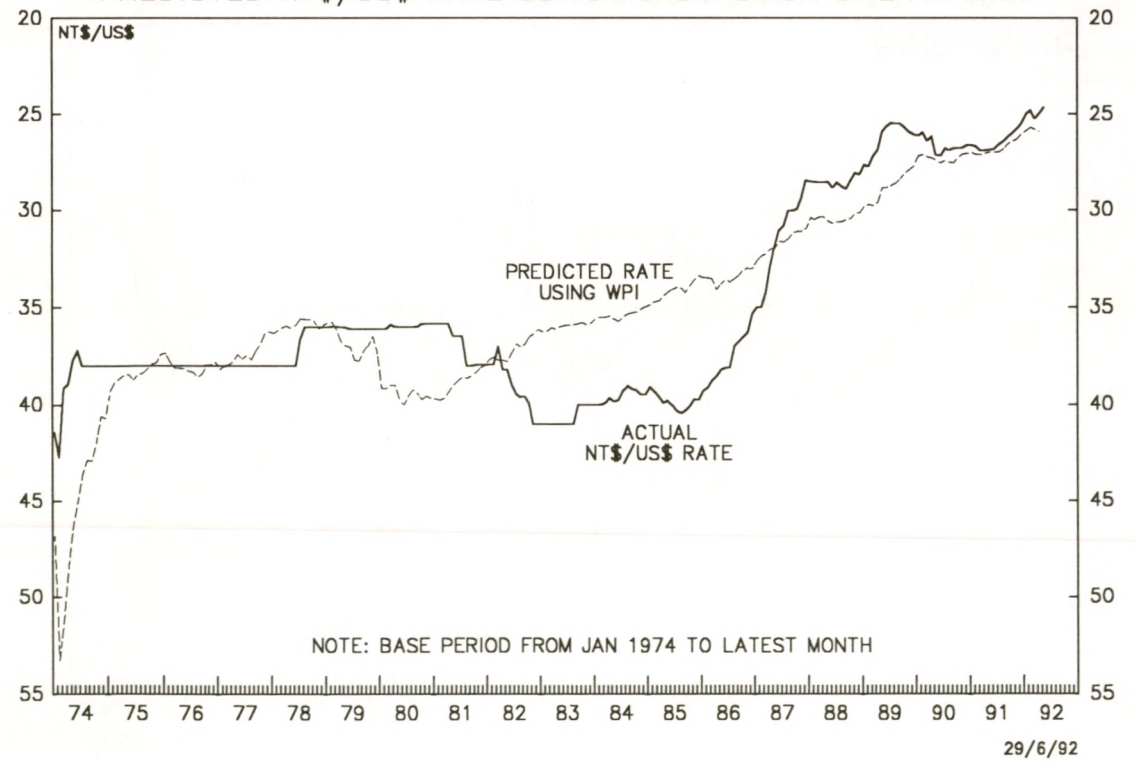
R.E.E.Rs OF INDONESIA, MALAYSIA, THE PHILIPPINES AND THAILAND



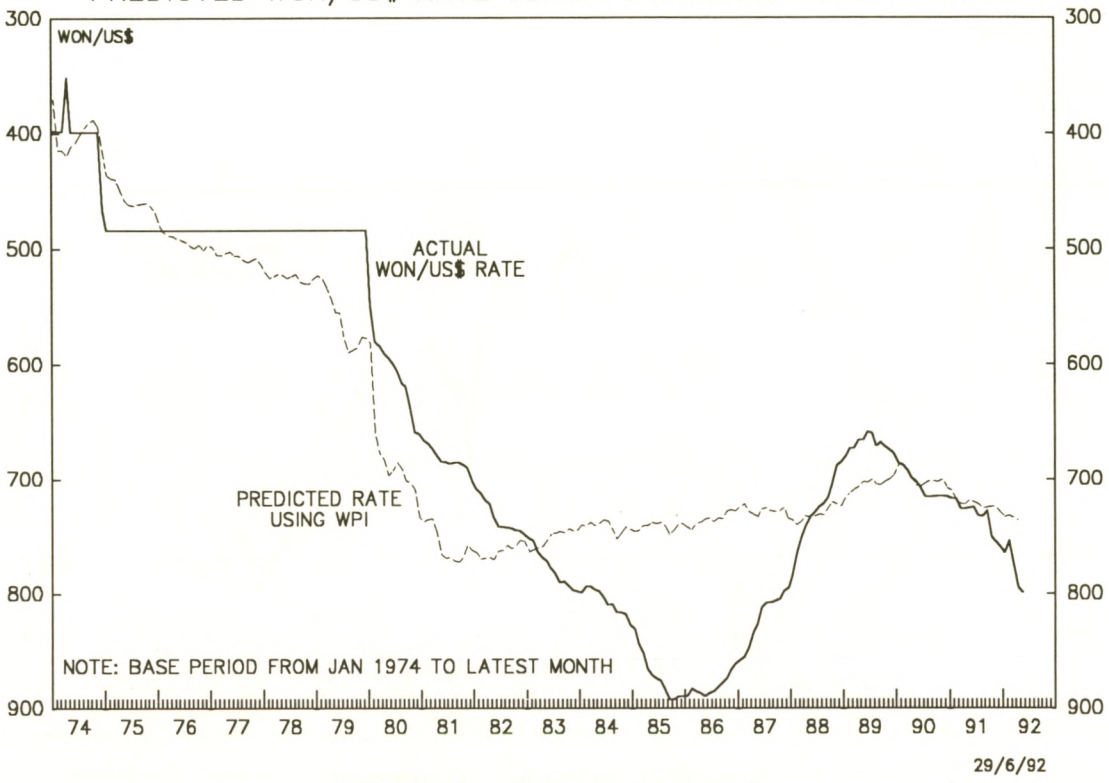
REGIONAL SURVEY: CHART 6
PREDICTED HK$/US$ RATE USING PURCHASING POWER PARITY



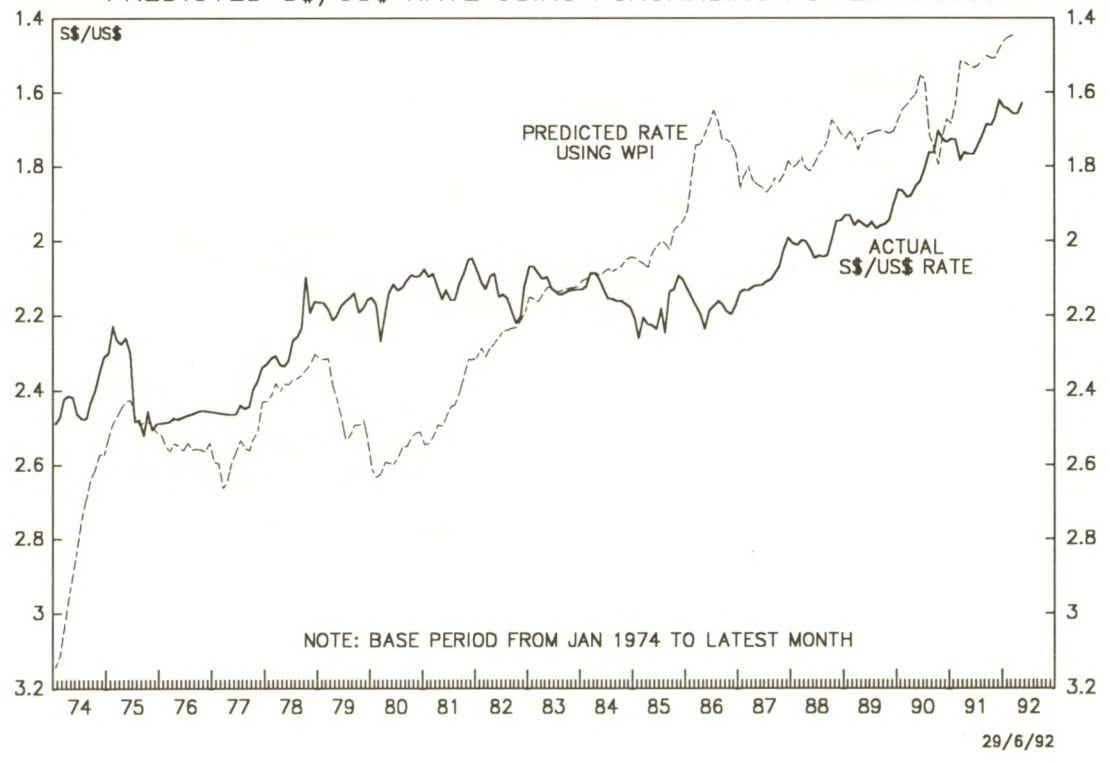
REGIONAL SURVEY: CHART 7
PREDICTED NT$/US$ RATE USING PURCHASING POWER PARITY



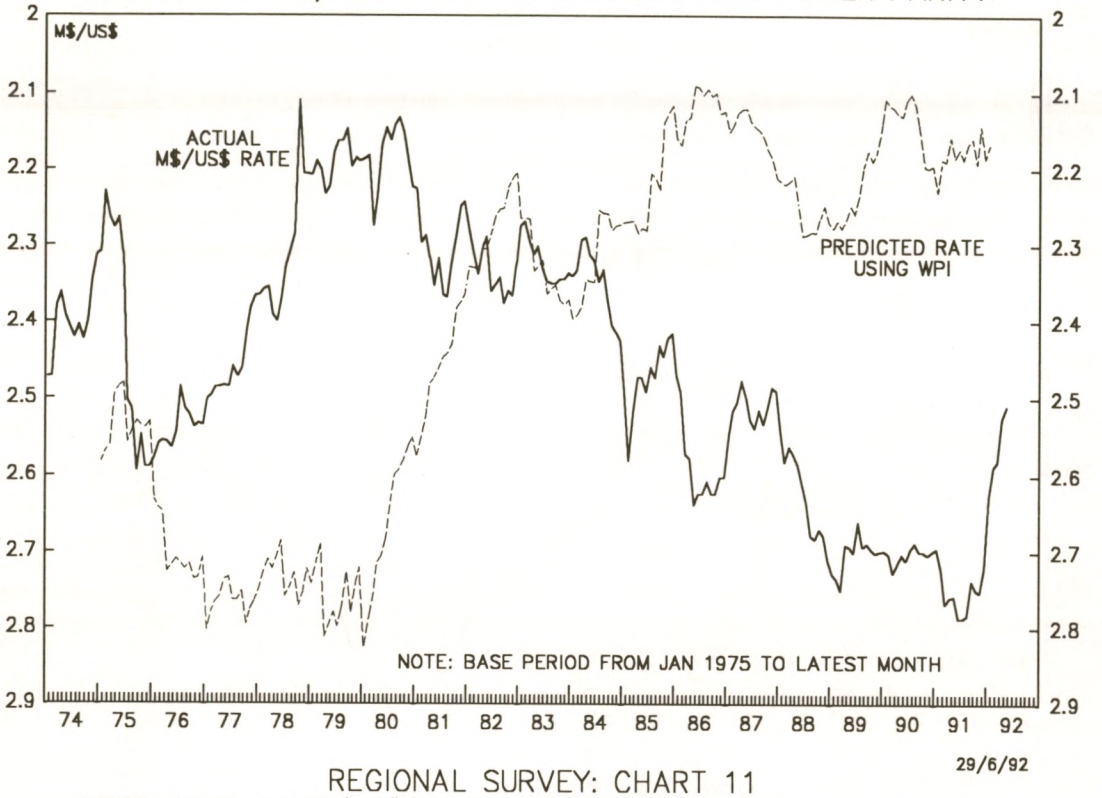
REGIONAL SURVEY: CHART 8
PREDICTED WON/US$ RATE USING PURCHASING POWER PARITY



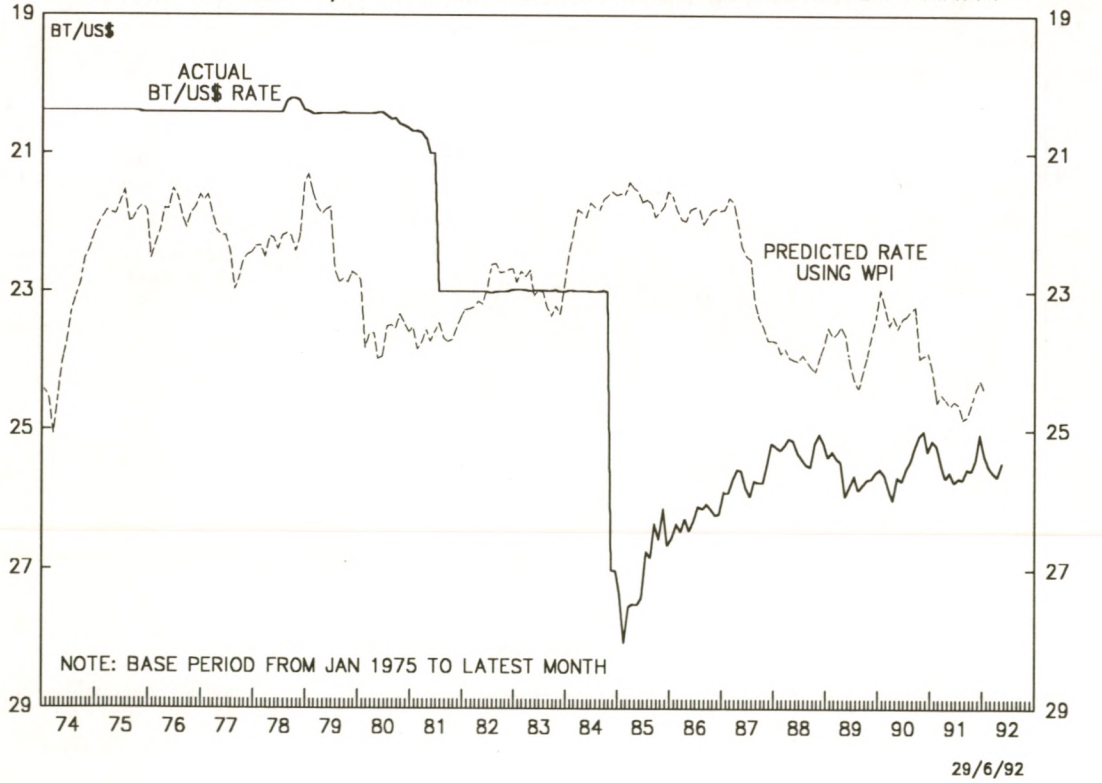
REGIONAL SURVEY: CHART 9
PREDICTED S$/US$ RATE USING PURCHASING POWER PARITY



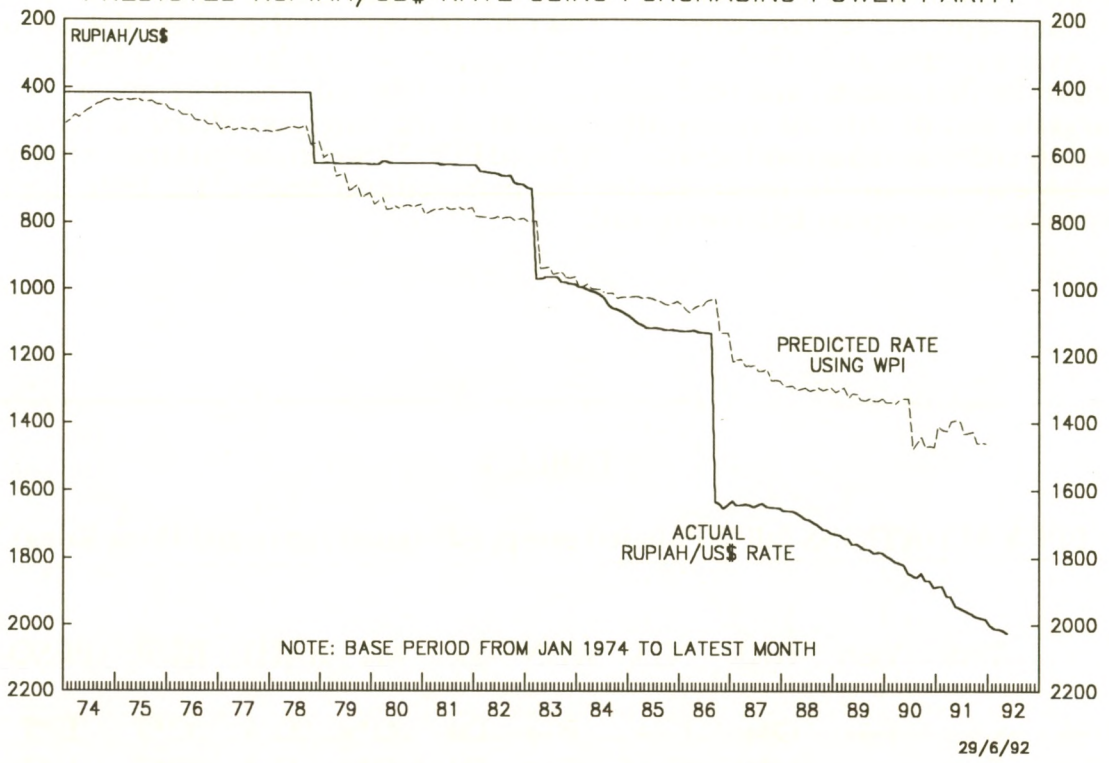
REGIONAL SURVEY: CHART 10
PREDICTED M$/US$ RATE USING PURCHASING POWER PARITY



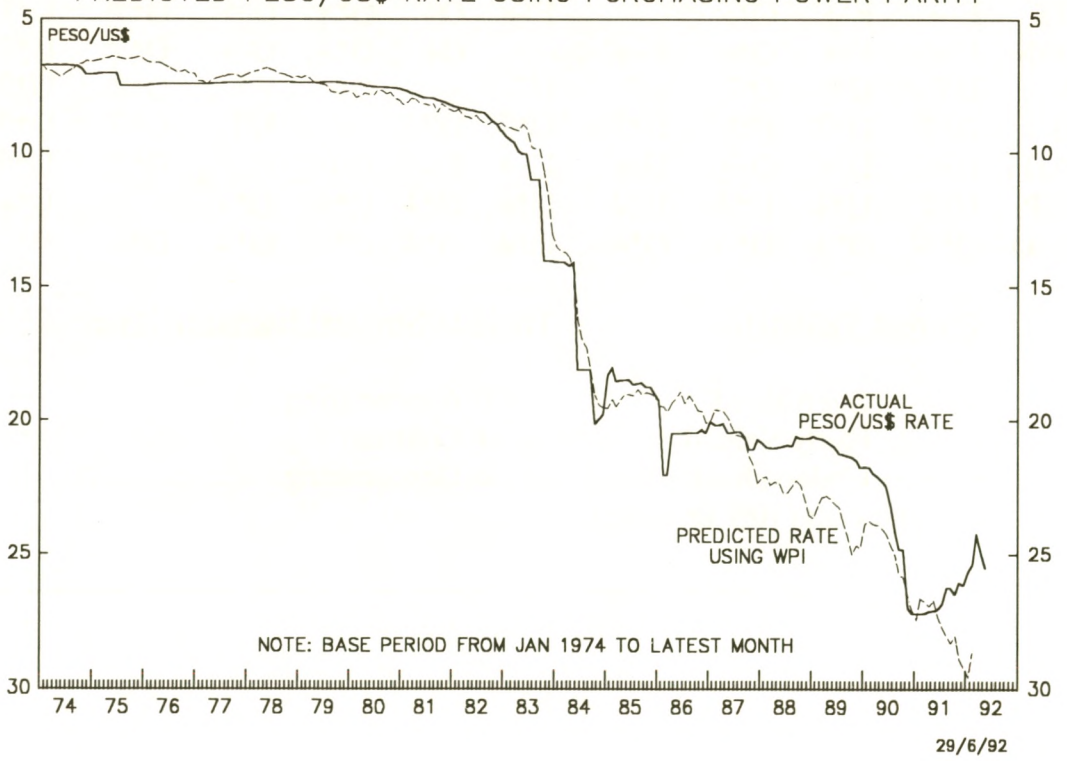
REGIONAL SURVEY: CHART 11
PREDICTED BAHT/US$ RATE USING PURCHASING POWER PARITY



REGIONAL SURVEY: CHART 12
PREDICTED RUPIAH/US$ RATE USING PURCHASING POWER PARITY



REGIONAL SURVEY: CHART 13
PREDICTED PESO/US$ RATE USING PURCHASING POWER PARITY



Charts 6-13 show the PPP and nominal exchange rates of these 8 east Asian economies against the US dollar. The results are summarised in Table 1 where the columns represent the base currency. This table first appeared in AMM Vol. 14 No. 4. As an example, to check the value of the Singapore dollar relative to the US dollar, select the first column and read down to the row labelled Singapore dollar. This suggests that despite the steady appreciation of the Singapore dollar, it remains slightly undervalued according to its WPI-based PPP. However, despite the currency's steady appreciation, the undervaluation has persisted over much of the 1980s due to Singapore's exemplary inflation record.

TABLE 1

PPP VALUATIONS (all WPI-based except EPI-based Japan and Hong Kong)

	US$	YEN	HK$	NT$	WON	S$	M$	BAHT	RUP.	PESO
US$	-	F→	O*→	F→	F→	O↓	O*↓	O→	O*↑	U*↑
YEN	F→	-	O*→	F→	F→	O↓	O*↓	O→	O*↑	U*↑
HK$	U*→	U*→	-	U*→	U*→	U↓	F↓	U→	O*↑	U*↑
NT$	F→	F→	O*→	-	F→	O↓	O*↓	O→	O*↑	U*↑
WON	F→	F→	O*→	F→	-	O↓	O*↓	O→	O*↑	U*↑
S$	U↑	U↑	O↑	U↑	U↑	-	O↓	F↑	O*↑	U*↑
M$	U*↑	U*↑	F↑	U*↑	U*↑	U↑	-	U↑	O*↑	U*↑
BAHT	U→	U→	O→	U→	U→	F↓	O↓	-	O*↑	U*↑
RUP.	U*↓	U*↓	U*↓	U*↓	U*↓	U*↓	U*↓	U*↓	-	U*→
PESO	O*↓	O*↓	O*↓	O*↓	O*↓	O*↓	O*↓	O*↓	O*→	-

Current Valuation

O = Overvalued
F = Fairly Valued
U = Undervalued
* significant (10% or more)

Trend in Nominal Exchange Rate

↑ Appreciating
→ Constant
↓ Depreciating

The major conclusions of the table are as follows. First, the Taiwanese and Korean currencies appear to have unwound much of the overvaluation that emerged in the late 1980s, and are now reasonably fairly valued against the US dollar and the Yen. Second, the Hong Kong dollar is around 10% undervalued against the US dollar at the current pegged exchange rate. Nevertheless, given the belief that the Hong Kog dollar was pegged at a "fair" exchange rate in October 1983, a case can be made for restricting the calculation of the PPP to the post 1983 period. This PPP implies that the Hong Kong dollar remains fairly valued. Third, despite appreciating over 10% against the US dollar since mid-1991, the Malaysian Ringgit has yet to fully reverse the "cheap" currency policy of the 1980s, and remains perhaps 10% undervalued. Fourth, the Thai Baht is slightly undervalued against the US dollar, but not significantly so. Fifth, the Indonesian Rupiah remains the most undervalued of all the Asian currencies -- maybe as much as 25% -- but continues to depreciate. Finally, the Philippine Peso is now significantly overvalued following the effective reversal of the 1990 devaluation. However, it has recently started to depreciate and can be expected to move back towards its "fair" value over 1992.

CONCLUSIONS: According to our crude currency valuations, most east Asian economies have managed to maintain their competitiveness over the last 20 years, and despite the protestations of often vocal export lobbies, none have significantly overvalued currencies (save the temporarily overvalued Peso) vis-a-vis the US dollar. The revaluation of the nominal exchange rates of north east Asia during the mid 1980s has harmed their competitiveness relative to their south east Asian counterparts, but their currencies are not expensive relative to global valuations. This proposition is supported by continued strong export growth, and should be reinforced by a pick up in this growth as the US emerges slowly from recession.

HONG KONG
RECENT TRENDS IN CURRENCY SUBSTITUTION

by Y.C. Jao, School of Economics, University of Hong Kong

The past two decades have been one of the most tumultuous periods in Hong Kong's monetary history. During that short span, there have been no less than three different exchange rate regimes, and one currency crisis that nearly brought down the whole financial system. These events have been well-documented, but a related phenomenon, currency substitution, has yet to be systematically explored. The purpose of this article is to provide a non-technical overview of the problem, and to draw some broad policy conclusions.

I. A Brief Conceptual Review

In the current literature currency substitution is often loosely equated with "currency switching" or "currency diversification". We would prefer a more precise and explicit definition as follows. Currency substitution is a tendency for a domestic currency to be systematically replaced by one or more foreign currencies in discharging normal monetary functions, i.e., medium of exchange (means of payment), store of value etc.

In Latin America, currency substitution is more popularly known as "dollarisation", which means, of course, the widespread use of the US dollar for both transactions and asset-holding purposes. It is not often appreciated that in the Far East, the term can refer to the Hong Kong dollar. For instance, it is well-known that the Hong Kong dollar is the preferred currency in China's Special Economic Zones (Jao, 1986) and Macau. There are no official data on the circulation of the Hong Kong dollar in South China and Macau, but private estimates have been made (Greenwood, 1990). The intriguing thing is that, inside its own borders, the Hong Kong dollar is the object of currency substitution.

The term "currency substitution" appeared about twenty years ago, soon after the collapse of the Bretton Woods system. Prior to that, advocates of the flexible exchange rate regime had been in the ascendancy for some time. They argued that the flexible exchange rate regime would not only provide an automatic equilibrating mechanism for the foreign exchange market, but would also insulate a country from external disturbances, and allow it to pursue an independent monetary policy. This view was put forward most forcefully by the eminent economist, the late H.G. Johnson (1972, p.199) as follows:

"The fundamental argument for flexible exchange rates is that they would allow countries autonomy with respect to their monetary, fiscal and other policy instruments.....The argument for flexible rates can be put more strongly still: flexible exchange rates are essential to the preservation of the national autonomy and independence consistent with efficient organization and development of the world economy. "

With hindsight, one can now see that this view is over-optimistic and simplistic, even though it appeared reasonable at the time. One obvious drawback is the greater-

than-expected exchange rate volatility. Dornbusch (1990) shows that volatity in real exchanges rates has been on the order of 30 or 40 per cent after 1973, in contrast to the view implied in the Quantity Theory and Purchasing Power Parity (PPP) theory that real exchange rates should be approximately constant. Proponents of flexible rates have largely ignored the possibility that, with the "external discipline" of the fixed exchange rate regime gone, a country may well pursue an independent but irresponsible monetary policy. They have also overlooked another important development, namely, the growing integration of the world economy and financial markets, as a result of which no country can be immune to the monetary and fiscal policy consequences of other countries, whatever the exchange rate arrangements. This holds especially, of course, for small open economies like Hong Kong.

From the perspective of this paper, the most important criticism is that while the proponents of flexible rates are undoubtedly correct in asserting that monetary policy is rendered impotent by currency substitution on the supply side, they have completely ignored currency substitution on the demand side. It may be helpful to the readers to amplify this conceptual distinction. Supply side currency substitution normally occurs under a fixed exchange rate regime, where the domestic currency is fully backed by a precious metal, or by another major foreign currency, so that they are fully and freely convertible into each another. The classic examples are the international gold standard before 1931 (excluding suspension of specie payments during wars), and the Currency Board system, of which Hong Kong's present monetary system is a variant. Demand-side currency substitution, on the other hand, can in principle occur under any exchange rate regime. This means that transactors or wealth-holders will readily switch from domestic currency to foreign currency or currencies, and vice versa, in response to various signals and incentives. It follows that a demand function for domestic money that includes both domestic and foreign variables as arguments will be much more unstable than that which includes domestic variables only. One obvious implication is that monetary policy is likely to be less effective than it would otherwise be in the presence of currency substitution. Kareken and Wallace (1981) and Girton and Roper (1981) have rigorously demonstrated how exchange rates can be rendered indeterminate by unbridled currency substitution under a flexible rate regime. That this is not merely an academic exercise has been shown vividly by the Hong Kong experience in 1982-83. Yet most pre-1970 studies had assumed that domestic residents can hold domestic currencies only. McKinnon (1982) shows that in the presence of currency substitution, the domestic money stock is a poor predictor of both national and world inflation.

II. Measurement of Currency Substitution

Following our definition in the previous section, one can use the ratios of foreign currency deposits (FCDs) to total deposits and monetary aggregates and observe whether they have been rising over time.

Foreign currency components of Hong Kong's banking and monetary statistics date from the end of 1980 only. The time series is therefore relatively short. Moreover, using raw data may yield misleading results. This can be shown in Table 1, which gives the ratio of FCDs to total deposits from December 1980 to March 1992.

Table 1

Unadjusted Customers' Foreign Currency Deposits in All Authorised Institutions

End of year/month	All Foreign Currency Deposits	
	Amount (HK$mn)	Proportion of Total Deposits (%)
1980	17,720	13.76
1981	29,266	17.86
1982	97,381	41.60
1983	134,642	46.74
1984	161,776	45.57
1985	218,680	50.76
1986	305,549	55.49
1987	394,066	56.01
1988	498,776	58.99
1989	620,017	61.50
1990	784,545	62.75
1991	817,501	58.61
1992 (Mar.)	818,570	59.40

Source: Underlying data from Monetary Affairs Branch, Hong Kong Government

According to the table, the proportion of FCDs to total deposits rose steadily during the period from just under 14% to over 59%. The picture is misleading however for two reasons. First, official statistics are expressed in terms of Hong Kong dollars, so that any depreciation of the local currency automatically inflates the value of FCDs. This is of course the "valuation effect". Second, "swaps deposits" are included under FCDs, though for analytical purposes they should more properly be regarded as Hong Kong dollar deposits.

To eliminate the first effect, we use the constant effective exchange-rate index at the end of 1980 for converting the current value of FCDs. In other words, the formula for adjustment is $V_a = V_t . E_t/E_b$, where V_a is the adjusted value, V_t is the unadjusted value in the current period, E_t is the effective exchange rate index in the current period, E_b is the effective exchange rate index in the base period. To eliminate the second effect, we deduct "swap deposits" from FCDs. The result is given in Table 2.

Table 2

Adjusted Foreign Currency Deposits in All Authorised Institutions

End of Year/Month	All Foreign Currency Deposits	
	Amount (HK$mn)	Proportion of Total Deposits (%)
1980	10,642	8.26
1981	19,504	11.90
1982	75,635	32.49
1983	88,421	30.70
1984	115,797	32.60
1985	172,286	40.00
1986	233,899	42.50
1987	302,306	43.00
1988	354,472	41.90
1989	440,717	43.70
1990	594,243	48.30
1991	645,532	47.00
1992 (Mar.)	669,827	48.61

Source: as for Table 1

By the same methodology, we can compile adjusted foreign currency components of the three monetary aggregates, namely, total M1, total M2, and total M3. The results are presented in Table 3.

Table 3

Adjusted Foreign Currency Components of Monetary Aggregates

End of	Total M1		Total M2		Total M3	
Year/Month	Amount (HK$mn)	% of Total	Amount (HK$mn)	% of Total	Amount (HK$mn)	% of Total
1980	1,122	4.64	10,755	11.18	11,232	8.09
1981	1,408	5.59	13,760	11.78	21,081	11.92
1982	1,270	4.62	67,029	32.43	78,909	31.53
1983	2,028	6.56	78,487	30.45	91,734	29.89
1984	2,812	7.64	99,249	31.60	119,751	31.94
1985	3,068	6.78	151,820	38.90	172,286	39.99
1986	3,791	6.75	212,646	41.04	239,080	41.06
1987	6,547	7.99	279,661	41.31	307,527	41.37
1988	7,460	8.40	331,738	40.23	358,768	40.16
1989	7,657	8.07	412,886	41.75	445,318	42.00
1990	13,104	12.19	560,173	46.29	598,970	46.50
1991	14,016	10.91	615,790	44.92	651,212	45.31
1992 (Mar.)	12,231	9.42	640,704	46.45	673,844	46.78

Source: As for Table 1

Since the time series in Table 2 and 3 have been adjusted for both "valuation effect" and "swap effect", the foreign currency proportions consequently represent "real" changes and not just "nominal" changes. With regard to total deposits in Table 2, the proportion of FCDs generally followed an uptrend, with a noticeable "quantum jump" in 1982. However, the foreign currency component of total M1 did not show any consistent uptrend: after reaching a peak of 12.19% in 1990, it has tended to fall since then. Moreover, the proportion has generally been within the single digit range, and there was no "quantum jump" in 1982. This shows that currency substitution is not an important factor as far as the medium of exchange or means of payments function is concerned. However, for total M2 and total M3, which are held primarily for the store of value function, the uptrend has been much more consistent and noticeable. Furthermore, in both cases there was a "quantum jump" in 1982. This was no mere coincidence. 1982 was the year of course when the 1997 problem became a formal diplomatic issue between China and Britain, and the protracted negotiations on the future of Hong Kong immediately touched off a confidence crisis. There can be no doubt that there was a massive switch towards FCDs as a hedge against political risk and uncertainty, especially as there was at that time a tax advantage in favour of FCDs. However, whereas accelerated currency substitution in 1982-83 eventually led to the great crisis of September 24, 1983, since the establishment of the linked exchange rate system on October 15, 1983, further currency substitution has not resulted in any similar panic.

Currency substitution also manifests itself in the growing foreign currency components of the consolidated balance sheet of the banking system, defined broadly here to include all the 3-tier depository institutions. This is shown in Tables 4 and 5, where the time series have also been adjusted for the "valuation effect" and the "swap effect", where applicable. Three salient features differentiate these two tables from the previous three. First, even before the 1997 issue surfaced in 1982, the foreign currency components of the total liabilities and assets of the banking system were well above 50%, reflecting no doubt Hong Kong's importance as an international financial centre. Second, there was no "quantum jump" in the foreign currency proportions in 1982. Third, the uptrend has been much more measured and steady.

It might be useful to distinguish here between two effects, the "financial intermediation effect" and the "portfolio shift effect". The former effect describes the fact that a large number of international financial institutions congregate in Hong Kong and routinely transact business both onshore and offshore without being unduly sensitive to political risk or uncertainty. The latter effect denotes the behaviour of individual wealth-holders who are far more sensitive to political risk and uncertainty, especially when they are mostly domestic residents. Generally speaking, one can say that Tables 1-3 are dominated by the portfolio shift effect, while Tables 4 and 5 are dominated by the financial intermediation effect. However, one must be realistic enough to recognise that it is in practice extremely difficult, if not impossible, to disentangle these two effects, particularly as neither the authorities nor the banking system in Hong Kong require bank customers to report their residential status.

Table 4

Adjusted Foreign Currency Components of Total Liabilities of All Authorised Institutions

End of Year/Month	Amount (HK$mn)	Proportion of Total Liabilities (%)
1980	225,335	51.76
1981	342,840	54.18
1982	485,411	56.24
1983	583,763	52.33
1984	706,951	55.68
1985	969,613	62.33
1986	1,365,563	63.50
1987	2,099,488	65.25
1988	2,304,393	62.31
1989	2,658,066	62.58
1990	3,533,652	67.51
1991	3,716,170	66.12
1992 (Mar.)	3,721,524	67.72

Source: As for Table 1

Table 5

Adjusted Foreign Currency Components of Loans and Other Assets of All Authorised Institutions

End of Year/Month	Foreign Currency Loans Amount (HK$)	Foreign Currency Loans Proportion of Total Loans(%)	Foreign Currency Assets Amount (HK$)	Foreign Currency Assets Proportion of Total Assets(%)
1980	80,049	43.52	244,854	56.24
1981	109,041	42.34	359,249	56.77
1982	135,442	40.89	496,140	57.48
1983	150,366	39.81	588,413	52.75
1984	175,034	41.57	721,200	57.28
1985	192,428	43.74	991,642	64.73
1986	211,197	42.19	1,391,914	66.28
1987	280,552	48.87	2,132,797	63.02
1988	434,326	45.14	2,330,332	63.02
1989	590,893	46.45	2,672,132	62.91
1990	987,340	55.20	3,547,662	67.78
1991	1,273,510	56.75	3,725,217	66.29
1992 (Mar.)	1,301,381	57.70	3,718,417	67.66

Source: As for Table 1

Because the foreign currency components of the banks' consolidated balance sheet are so substantial, there is naturally a concern about possible mismatch between foreign currency liabilities and assets. From Table 6, it can be seen that the relative long position or short position has been declining, so that by the end of March 1992 it had virtually disappeared. However, this does not necessarily mean that there is no mismatch for the banking system as a whole, for there is no information in the official statistics about the maturity structure. In symbols, let A and L be assets and liabilities of the banking system respectively. Then perfect matching means $A_{ij} = L_{ij}$, where i denotes the ith currency, and j the jth maturity, for all i, j.

In reality, this perfect matching is neither possible for the whole banking system, nor for any individual bank. For banking is essentially a business of "asset transformation" or "maturity transformation". In the course of daily business, bankers are inevitably and inextricably involved in "taking a view" on future currency movements. The art of bank management is how to minimise currency risk and maturity risk without abdicating the economic and social functions of banking.

Be that as it may, even though the mismatch may be minimal in relative terms, it can be sizeable in absolute terms. As shown in Table 7, the open position of the banking system at the end of March 1992 stood at $17,738 million, which though greatly reduced compared to the previous quarter, was not trivial. As Murphy's Law puts it, "if anything can go wrong, it will". The examples of Herstatt and Franklin National, whose collapse, due to forex losses, nearly triggered an international banking crisis in 1974, should serve as a vivid reminder. The need to monitor and control forex exposure at all times can therefore be hardly over-emphasised. In this connection, it is gratifying to note that the Banking Commissioner's office does have a set of guidelines on forex risks. Briefly, for Hong Kong incorporated institutions, the aggregate net overnight open position should not normally exceed 5% of capital base, and the net overnight open position in any individual currency should not normally exceed 10% of capital base. For Hong Kong branches of overseas banks, the Banking Commissioner's office only monitors managements' internal limits, but should the figures be over-large, it would review these with overseas head offices and if necessary, with the overseas supervisory authorities.

Table 6

Foreign Currency Mismatch in Balance Sheets of Authorised Institutions

End of Year/Month	Foreign Currency Proportion of Assets (%)	Foreign Currency Proportion of Liabilities (%)	Long Position (+) Short Position (-)(%)
1980	56.24	51.76	+4.48
1981	56.77	54.18	+2.59
1982	57.48	56.24	+1.24
1983	52.75	52.33	+0.42
1984	57.28	55.68	+1.60
1985	63.75	62.23	+1.42
1986	64.73	63.50	+1.23
1987	66.28	65.25	+1.03
1988	63.02	62.31	+0.71
1989	62.91	62.58	+0.33
1990	67.78	67.51	+0.27
1991	66.29	66.12	+0.17
1992 (Mar.)	67.66	67.72	- 0.06

Source: As for Table 1

Table 7

Foreign Currency Position of All Authorised Institutions (HK$mn.)

End of Year/Month	Spot Assets	Forward Purchases	Spot Liabilities	Forward Sales	Net Spot Position	Net Forward Position	Open Position
1980	241,517	128,915	228,936	124,858	+12,581	+4,057	16,638
1981	359,229	160,042	353,426	147,241	+5,803	+13,801	19,604
1982	550,833	241,601	570,330	204,009	-19,497	+37,592	18,095
1983	768,556	309,723	785,548	267,964	-16,992	+41,759	24,767
1984	913,057	350,472	909,753	329,956	+3,304	+20,516	23,820
1985	1,123,828	531,354	1,126,228	506,576	-2,400	+24,778	22,378
1986	1,633,223	819,045	1,642,849	776,772	-9,626	+42,273	32,647
1987	2,613,120	1,873,773	2,631,566	1,839,831	-18,446	+33,942	15,496
1988	2,992,961	2,679,321	3,014,254	2,625,493	-21,293	+53,828	32,535
1989	3,438,945	3,526,271	3,479,766	3,435,098	-40,821	+73,173	32,352
1990	4,367,836	4,659,047	4,424,664	4,590,762	-56,828	+68,285	11,457
1991	4,643,775	4,727,625	4,672,844	4,671,442	-29,069	+56,183	27,114
1992 (Mar.)	4,445,809	5,849,275	4,492,015	5,785,741	-46,206	+63,534	17,738

Source: Office of the Commissioner of Banking

III. Concluding Remarks

After purging the official data of distorting effects, the foreign currency components of total deposits and the broader monetary aggregates have all shown a general uptrend, thus confirming that currency substitution is a real phenomenon in Hong Kong. In general, it may be said that currency substitution is undertaken for the store of value function rather than the medium of exchange function. However, the true extent of currency substitution may be under-estimated, as the existing data relate to foreign currency balances held within the domestic banking system only. There are no reliable data on foreign currency balances held abroad by domestic residents, though they are believed to be substantial. Conversely, there may be significant foreign currency balances held in the Hong Kong banking system by non-residents.

One notable feature of Hong Kong's recent monetary history is that, whereas during 1982-83 massive currency substitution gave rise to an unprecedented currency crisis, since the establishment of the linked exchange rate regime in October 1983, continued currency substitution has proceeded in an orderly way without unduly adverse effects, even in the face of political shocks. The reason may well be that currency substitution on the demand side has been largely offset by currency substitution on the supply side. If financial stability is the primary objective of monetary and fiscal policies during Hong Kong's transition to 1997 and beyond -- an objective with which presumably few would disagree -- then the desirability of maintaining the present exchange rate regime and note-issuing mechanism should be obvious.

Currency substitution can also be observed from the rising foreign currency components of the consolidated balance sheet of the banking system. Here, however, the trend may reflect also Hong Kong's status as an international financial centre. It is therefore suggested that a conceptual distinction should be made between "financial intermediation effect" and "portfolio shift effect", though in practice it is difficult to disentangle the two. One major concern is the potential forex risk of the high foreign currency proportions. It is found that while the mismatch in relative terms is very small, the open position of the whole system in absolute terms is still considerable. The need for vigilant prudential supervision of such risk should again be self-evident.

Finally, it is worthy of note that whereas within Hong Kong, there is a trend of currency substitution against the Hong Kong dollar, outside its borders the Hong Kong dollar is displacing other domestic currencies, namely, the renminbi in South China and the pataca in Macau. This is an unusual, and perhaps, unique phenomenon. Indeed, one cannot think of any comparable instance in any other country.

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Notes:

1. The Banking Commissioner's circular letter on "Supervision of Foreign Exchange Risks" to Chief Executives of all authorised institutions, dated 31 May 1990.

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PHILIPPINES
GROPING IN THE DARK FOR AN ECONOMIC MIRACLE

The recent history of the Philippines is one characterised by feudal despotism, natural disasters and chronic economic mismanagement. As a result, the Philippines, which in the 1950s was Asia's richest country after Japan, has failed to share in the economic boom enjoyed by the rest of the region. While countries such as Thailand and Malaysia have enjoyed real average growth rates approaching double digits over the 1980s, the Philippines has limped along at only 1.6% per annum (Chart 1). Moreover, foreign direct investment (FDI) inflows which have contributed so much to economic expansion in the region, have failed to find their way to the archipelago, and have often been actively discouraged. FDI inflows over the 1980s averaged less than US$0.5 billion per annum, compared to figures of US$6.5 billion for Malaysia, US$4.9 billion for Thailand and US$8.8 billion for Indonesia (approvals) during 1990 alone (Chart 2). Nevertheless, the economic management displayed during the final year of the Aquino presidency gives rise to cautious optimism for the future.

The adherence to a stringent IMF Economic Stabilisation Programme (ESP), debt restructuring, and foreign exchange, trade and investment liberalisations, have laid the foundations for a sustainable acceleration in economic growth over the next decade. However, it remains to be seen whether Aquino's successor, ex-defence chief Fidel Ramos, will choose to follow similar macroeconomic policies. The early indications are positive, but after so many years of backtracking and squandered opportunities, it will require a lengthy period of time to establish international credibility.

The "Peoples' Power" revolution that toppled Ferdinand Marcos, and Cory Aquino's subsequent accession to the presidency in February 1986, appeared to promise a change in fortunes for the Filipino people. However, despite respectable growth rates over 1986-89 (Chart 3), economic management remained shoddy and little was done to address the economy's root problems of excessive money growth and overlarge fiscal deficits. To a certain extent this was understandable given the army's penchant for attempted coups -- 8 between July 1986 and October 1990 -- and a completely paralysed and ineffective legislature. These institutional problems were then compounded by power shortages, a serious and prolonged drought, typhoons, earthquakes and the Gulf war, which sent GDP growth tumbling to only 2.1% in 1990, and to -0.1% in 1991. Nevertheless, it still required a balance of payments crisis and a good deal of leverage from international credit agencies, to shock the administration into action.

In retrospect, the turning point appears to have been the October 1990 Peso devaluation. Foreign exchange reserves (Chart 4) had declined precipitously from the end of 1986, in line with worsening trade and current account deficits (Chart 5) resulting from excessive import growth (Chart 6). Reserves equivalent to less than one month's import coverage were being further depleted by the central bank's attempts to defend the Peso, while Filipino remittances from Iraq and Kuwait had dried up and international agencies were refusing to release new funds. This dire economic situation finally spurred the authorities into action, and the decision to devalue the Peso 8% against the US dollar (Chart 7) was swiftly followed by the adoption of the IMF's ESP in February 1991.

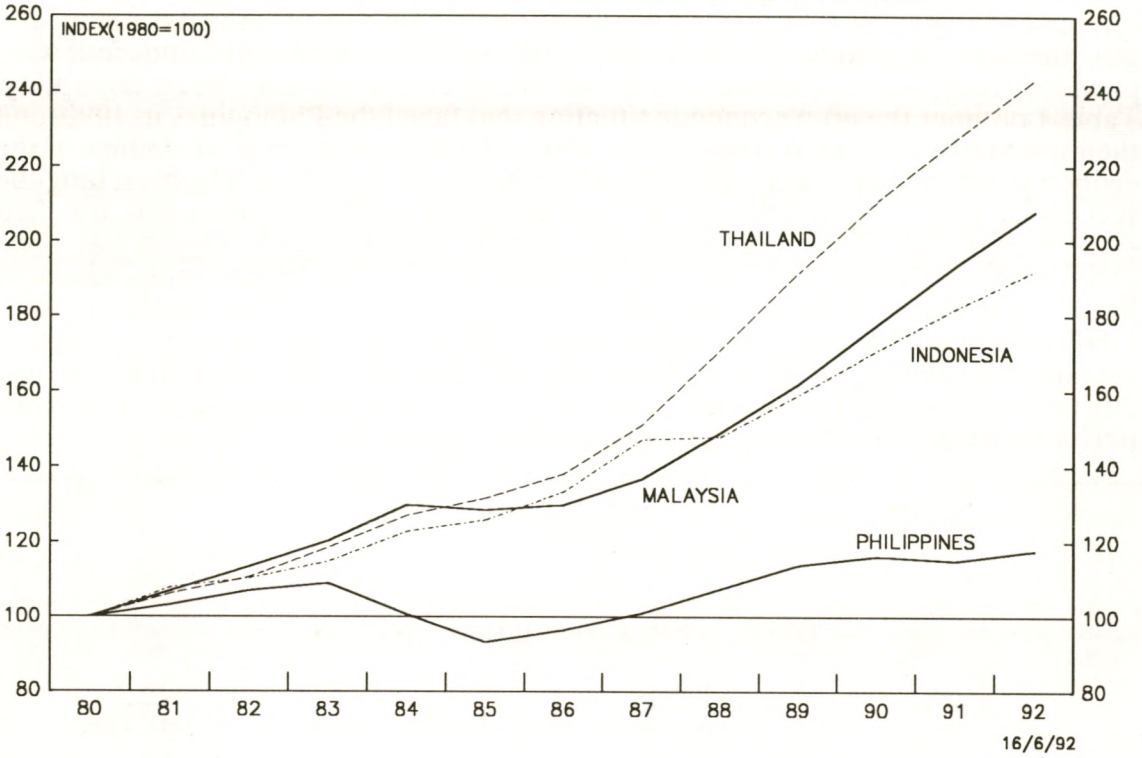
The ESP was accompanied by the release of US$916 million (payable in tranches over the life of the programme) from the IMF which replenished the level of foreign exchange reserves, opened the door to other sources of foreign funding, and gave the authorities some breathing space. However, in contrast to periods following previous foreign cash injections, economic management has since been exemplary. Table 1 outlines the grim economic situation that faced the Philippines in 1990, and then summarises the main targets of the ESP and the subsequent performance of the economy under these targets. The 1992 ESP targets are also given. The most tangible success has been the reduction in the fiscal and the consolidated public sector deficit -- the fiscal deficit, plus oil subsidies, plus deficits/surpluses at the central bank and other public sector corporations and institutions -- although the external indicators have also performed in line with IMF expectations. However, the failure to meet GDP, inflation and reserve money growth targets should not be taken as a sign of economic mismanagement, but can be attributed to special circumstances arising during 1991. Indeed, if one examines year-end figures as opposed to year averages, the performance is extremely satisfactory and encouraging.

TABLE 1

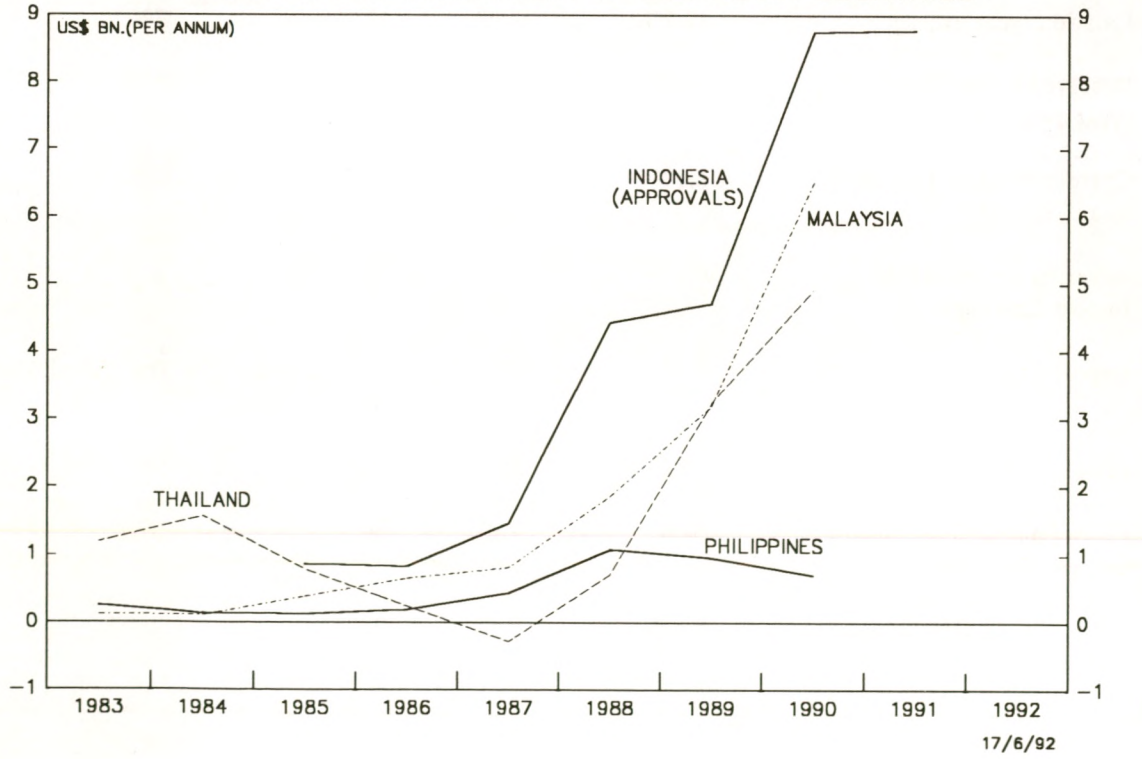
IMF ECONOMIC STABILISATION PLAN

	1990	1991		1992
	Actual	IMF Target	Actual	IMF Target
GDP Growth	2.1%	1-2%	-0.1%	2-3%
Inflation (year average)	12.7%	9.5%	17.7%	7%
Reserve Money Growth (year average)	30.4%	10%	25.2%	12%
Current Account Deficit as a % of GDP	6.1%	4.5%	2.6%	3%
Reserves per month of Import Coverage	0.9	2.5	2.4	3
Import Levy	-	9%	9% reduced to 5% in Aug.	0% (lifted May 1992)
Fiscal Deficit (Peso bn)	37.2	26.6	26.3	9.0
Consolidated Public Sector Deficit (Peso bn)	57.8	37.0	34.6	37.7
Public Sector Deficit as a % of GDP	5.5%	2.9%	2.7%	2.7%

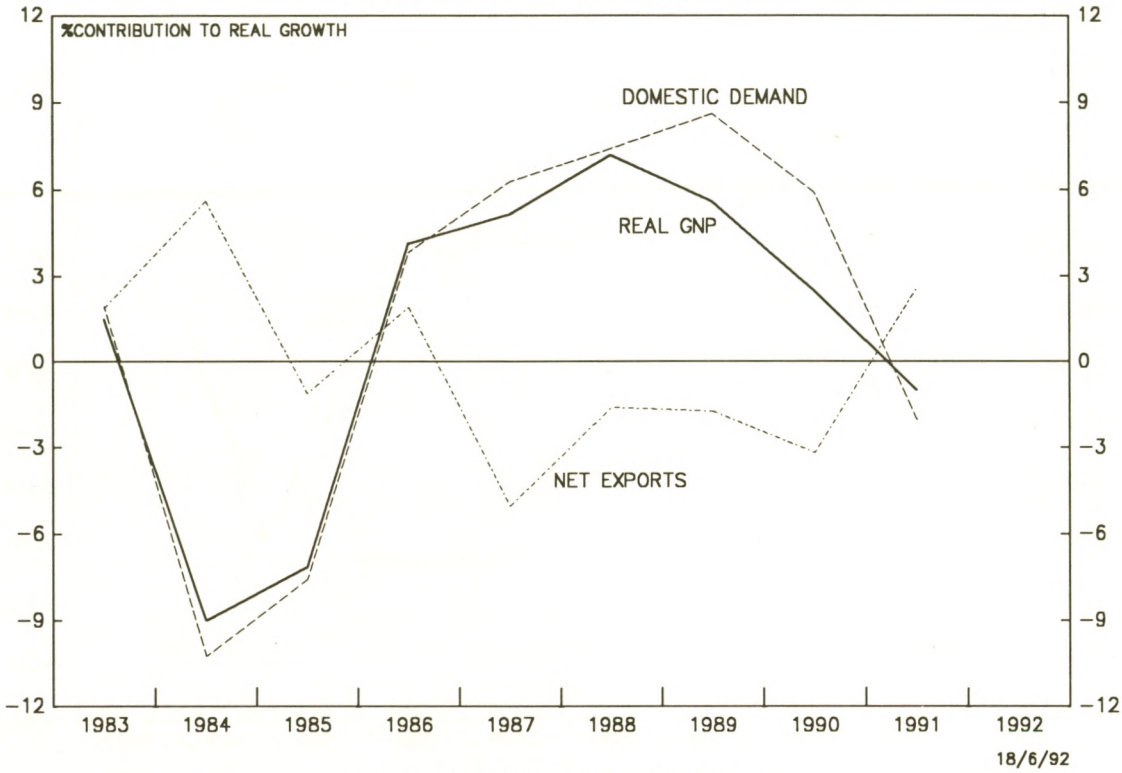
THE PHILIPPINES: CHART 1
GROWTH OF REAL GDP IN S.E.ASIAN COUNTRIES



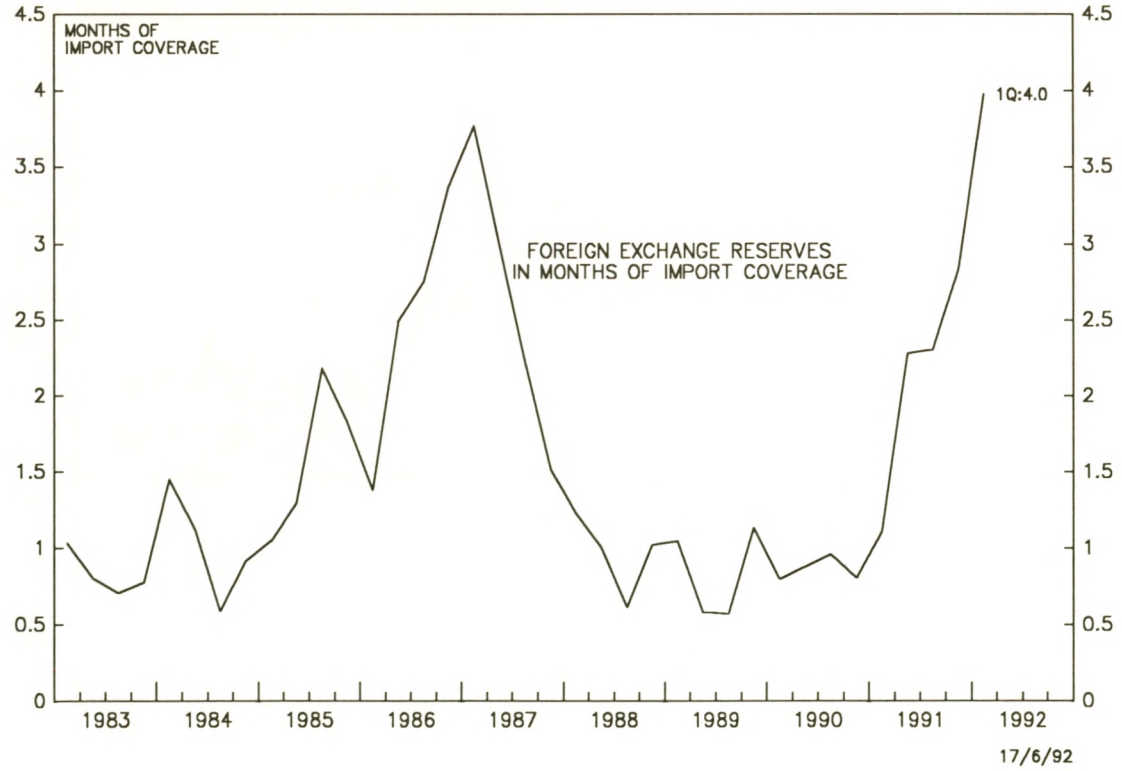
THE PHILIPPINES: CHART 2
FOREIGN DIRECT INVESTMENT IN S.E. ASIAN COUNTRIES



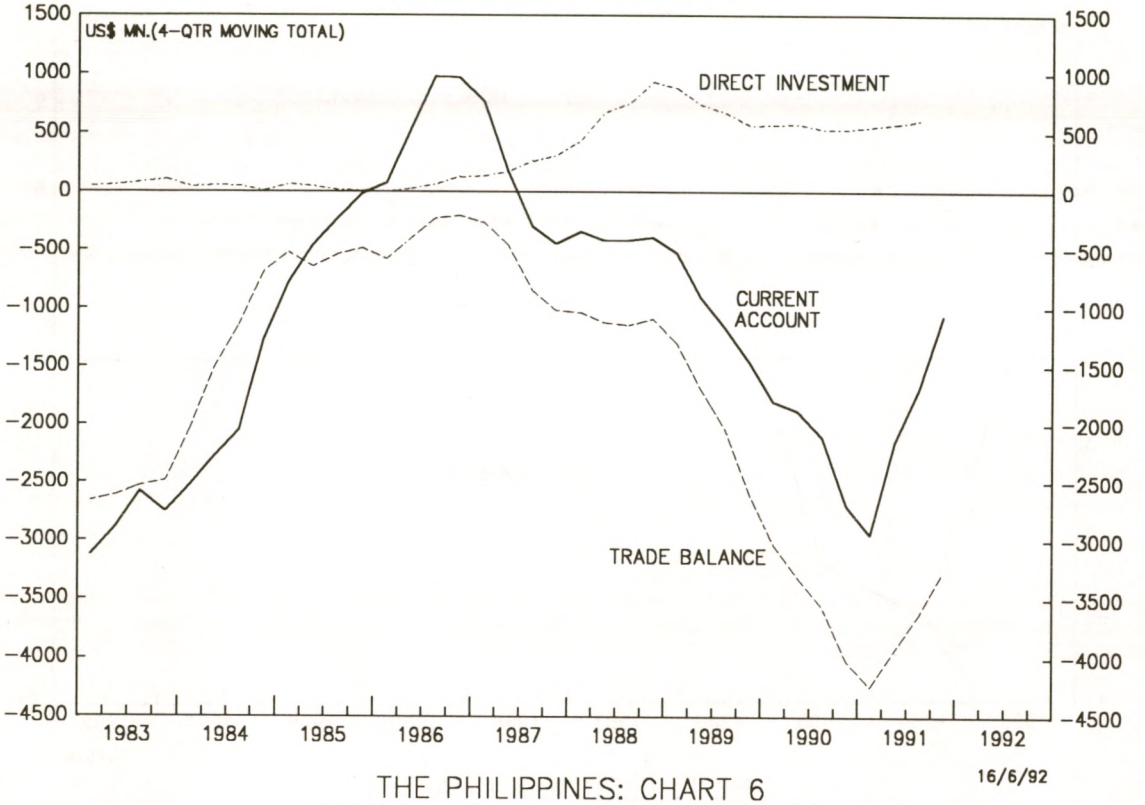
THE PHILIPPINES: CHART 3
COMPONENTS OF REAL GNP



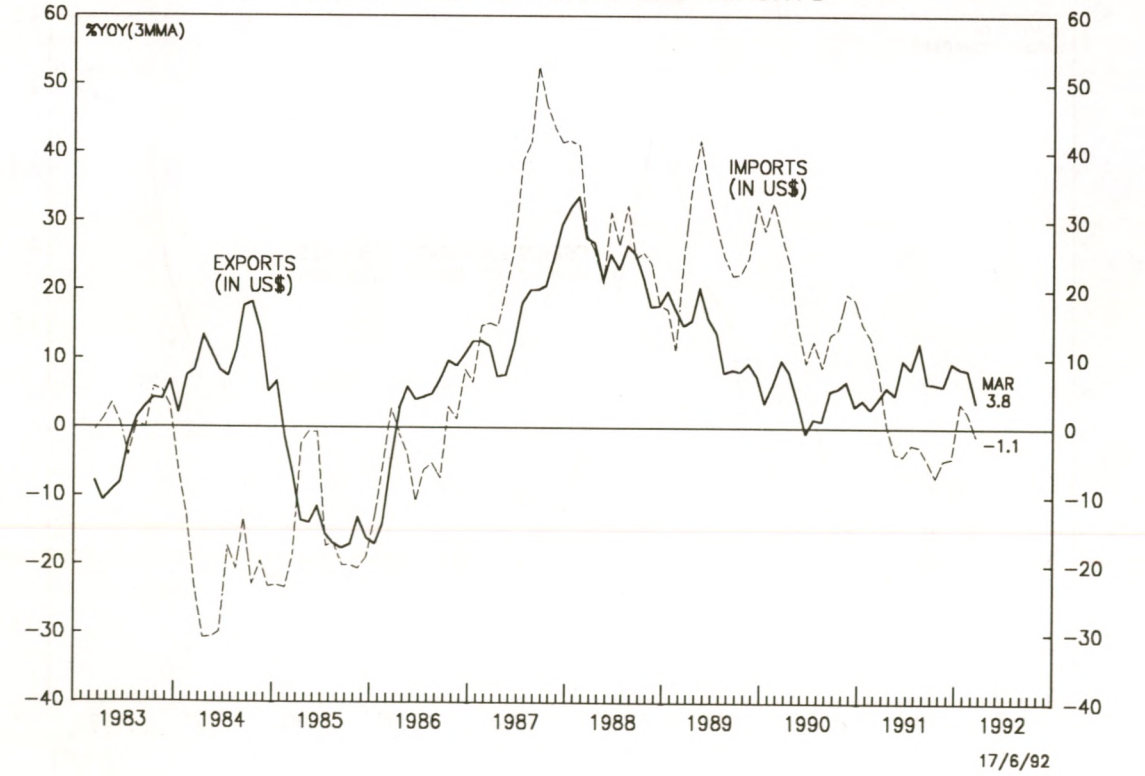
THE PHILIPPINES: CHART 4
RESERVES IN MONTHS OF IMPORT COVERAGE



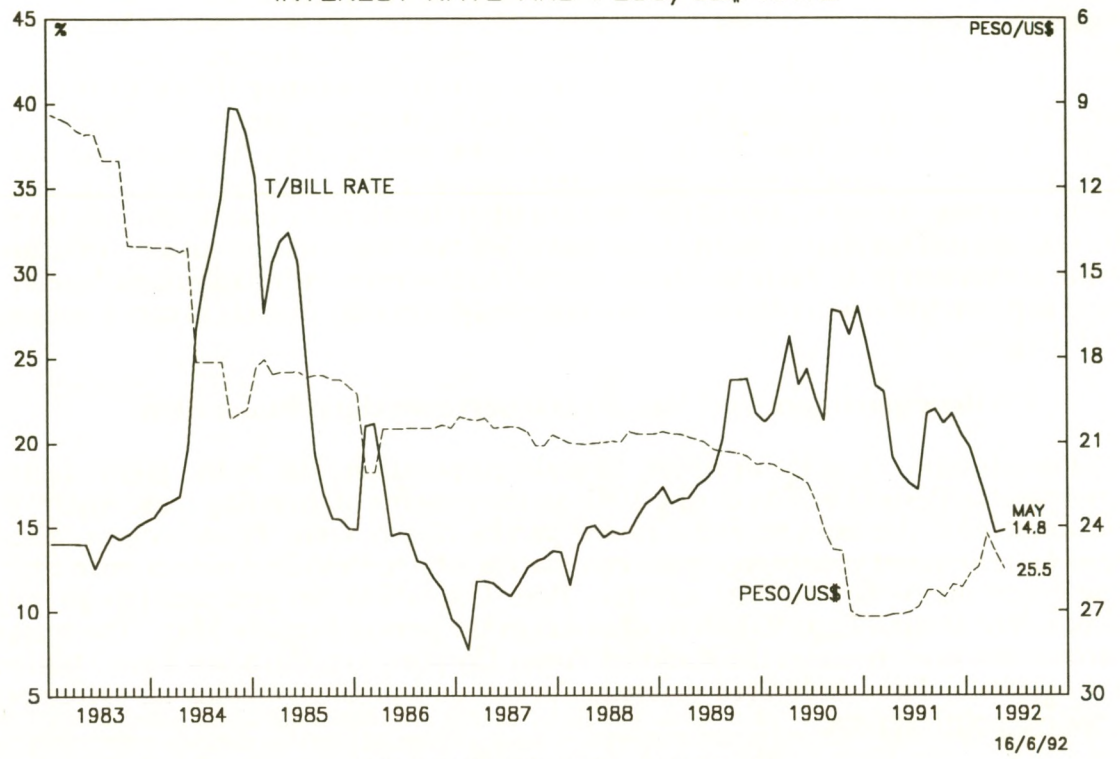
THE PHILIPPINES: CHART 5
BALANCE OF PAYMENTS



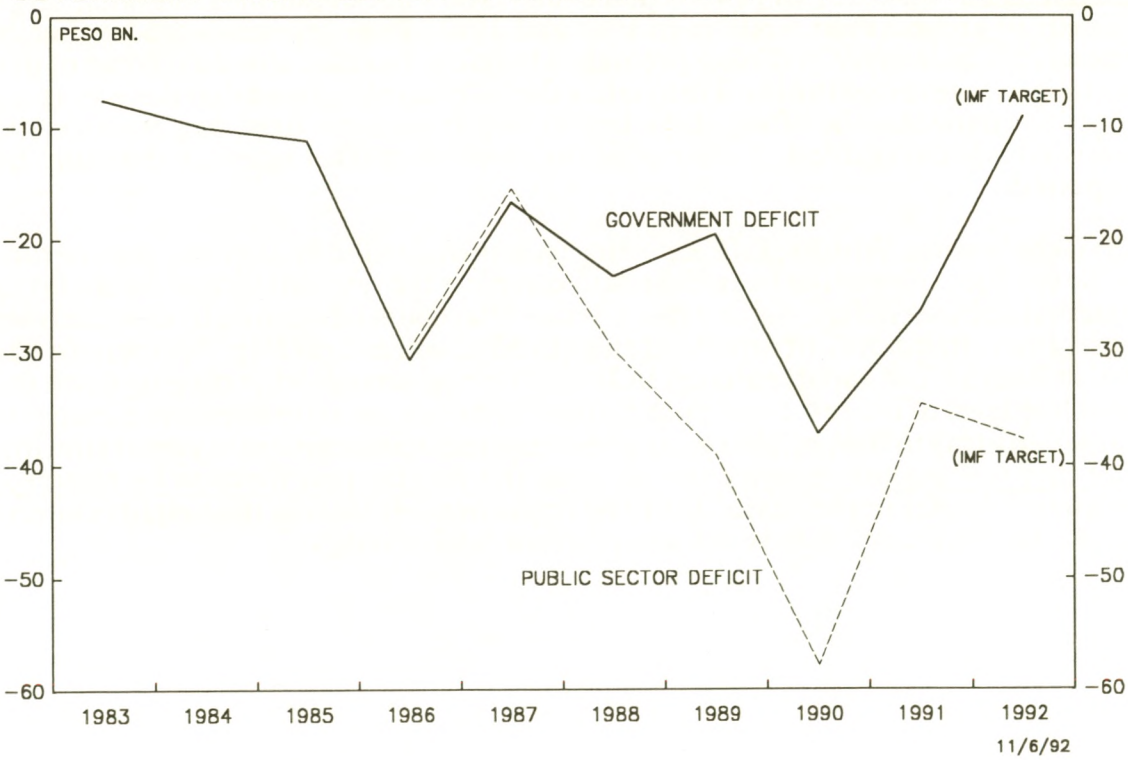
THE PHILIPPINES: CHART 6
GROWTH OF EXPORTS AND IMPORTS



THE PHILIPPINES: CHART 7
INTEREST RATE AND PESO/US$ RATE



THE PHILIPPINES: CHART 8
GOVERNMENT FISCAL DEFICIT & CONSOLIDATED PUBLIC SECTOR DEFICIT



Turning first to the fiscal deficits (Chart 8), the main test for the administration during 1992 will be to boost tax revenues. Revenues as a percentage of GDP have risen from a low of 11% in 1984, but at only 17%, they remain inadequate. Moreover, increased revenues during 1991 were almost entirely dependent on the 9% import levy which has now been removed. A proposed extension of the existing 10% VAT to cover services was voted down by a Senate dominated by precisely the professionals who stood to lose the most from this measure. This was one of only a few contraventions of an IMF directive and it is to be hoped that a second attempt will be more successful. Other revenue raising measures planned are simplifications in income and gift taxes, the setting up of tax courts, and new incentives for tax collectors and customs officials. In the absence of progress in this area, expenditures -- especially badly need development expenditure -- will continue to be squeezed disproportionately in order to meet IMF targets.

On the expenditure side, four areas deserve special consideration:

(1) Privatisation. The losses of the 14 main corporations still in the public sector amounted to Peso 12 billion during 1991, so the benefits of divesting these interests, not to mention the extra revenues raised, can be clearly seen. Privatisations raised Peso 4.2 billion last year bringing the cumulative total to Peso 28.7 billion since 1987. The government plans to raise a further Peso 15.6 billion this year and has already disposed of around Peso 10 billion of assets in the period January-May. The major burden, however, remains the National Power Corporation which lost Peso 7 billion during 1991. The whole area of energy policy and pricing remains an extremely sensitive political issue.

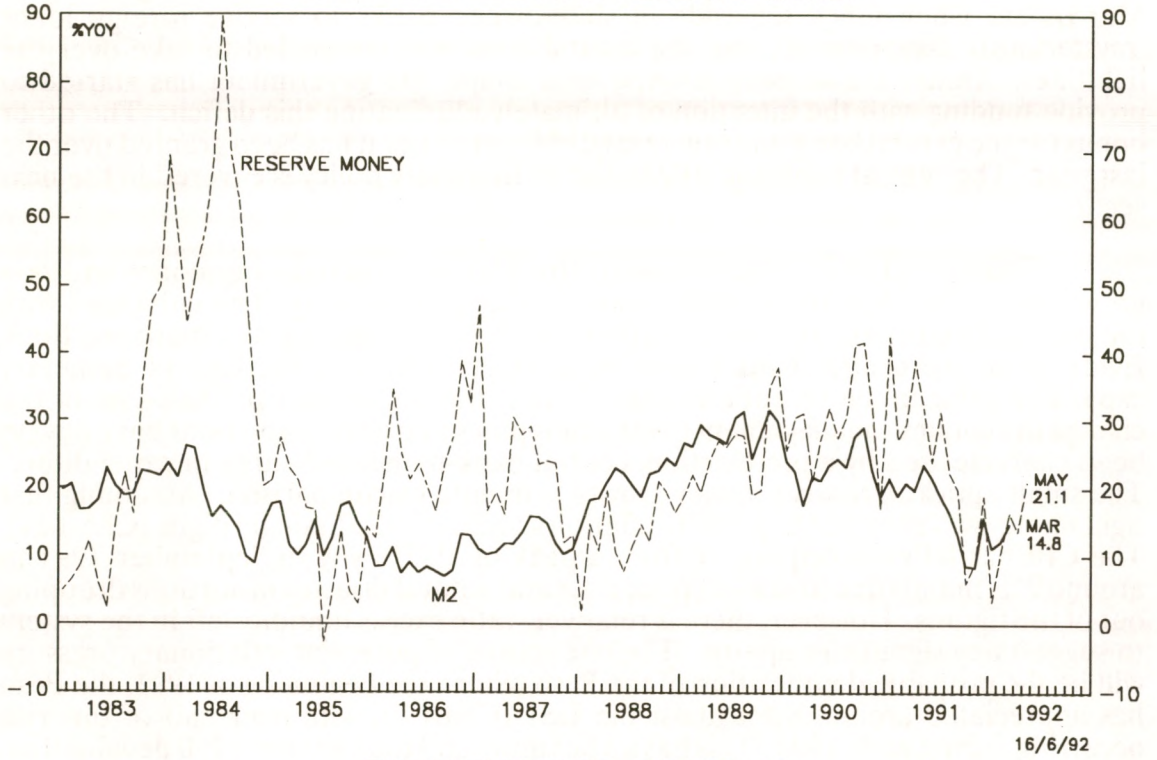
(2) The Oil Price Stabilisation Fund (OPSF). Fuel subsidies remain a major area of disagreement with the IMF, although the fund is now back in surplus following large deficits of around Peso 7 billion in 1989 and 1990. Energy prices were eventually raised 18% in January 1992 after prolonged haggling, but then about a quarter of this increase was reversed in May. Fortunately the IMF has recognised that this was a pre-election gimmick -- the lifting of the import levy at the same time, one month early, was similarly disregarded. Futher price rises towards market rates can therefore be expected.

(3) Debt Service. With the IMF signalling its approval of the Philippines' macroeconomic conduct, the way has been cleared to complete the restructuring of the country's external debt servicing. Since 1986, a series of accords have brought down service costs from almost 50% of export earnings to 33%, while short term debt service has fallen from 37% of export earnings to 20%. The new accords will not bring down the absolute level of interest costs much further (although the ratio to export earnings is targetted to fall to 20% within 5 years given reasonable assumptions of export growth), but they will smooth repayments and clear the way for new funds to be released. Various schemes implemented (or to be implemented) include debt-equity conversions, debt buybacks, debt swaps and payment reschedulings.

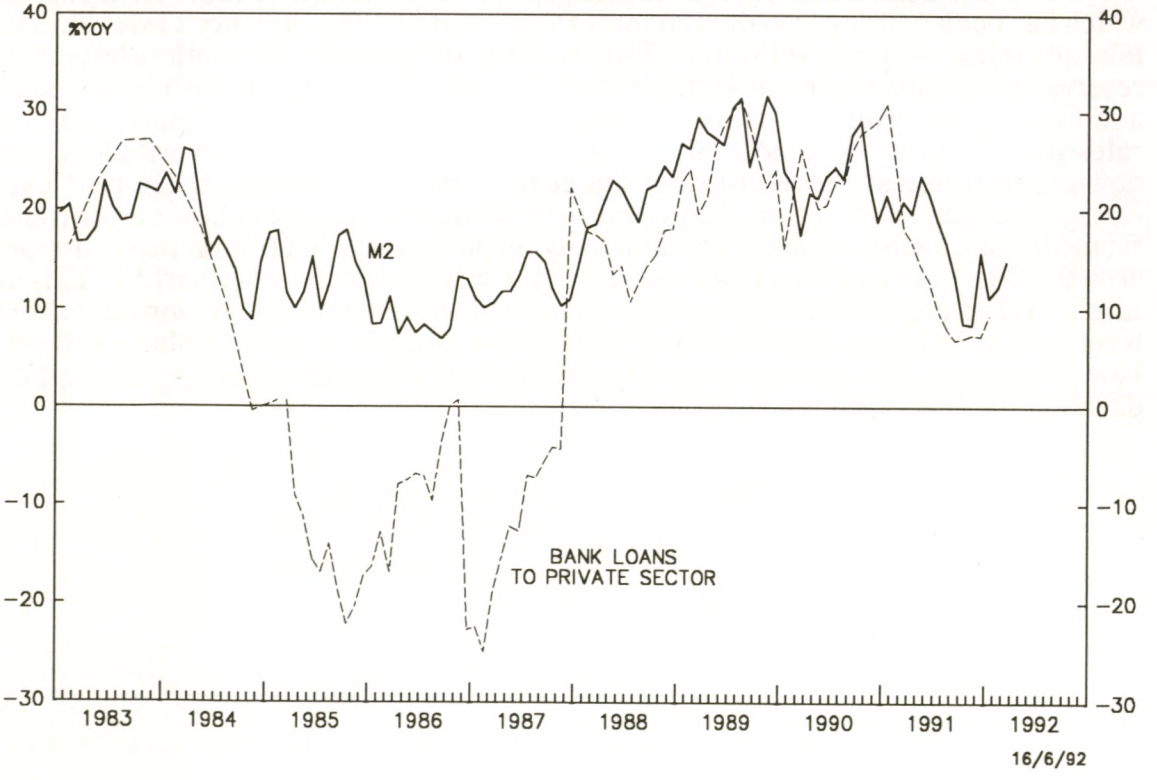
(4) The Central Bank Deficit. The biggest single drain on the public purse is the interest cost on the accumulated deficit of the central bank. This is a legacy of the Marcos era when funds set aside in state-owned banks to service foreign loans "mysteriously disappeared", and the central bank was compelled to take over the liabilities. Under the aforementioned debt swaps, the government has started to provide funding with the intention of ultimately eliminating this deficit. The other bonus for the central bank is the increased independence it has been granted over the last year. The central bank and its conduct of monetary policy is covered in the next section.

Charts 9 and 10 illustrate the central bank's success in reducing money and loan growth since the adoption of specific monetary targets last year. This coincided with the bank relinquishing its strict control of the Peso and moving to a managed float. Evidence of the central bank's new found independence is the lack of monetary expansion prior to the recent elections. This is the single most positive sign of the change in economic management in the Philippines as previous elections have always been characterised by a pre-election, central bank-monetised surge in expenditure. The small uptick in reserve money growth is minute by comparison. Assuming that tight money will continue to prevail, inflation should remain in single digits (Chart 11). The CPI has fallen precipitously from a peak of 19.3% yoy in September 1991 to around 9%, mainly due to one-off price rises and natural disaster distortions dropping out of the figures. However, there is relatively little excess liquidity left in the system to suggest any significant upturn. The one source of potential inflationary pressure will be the probable depreciation of the Peso. Since the beginning of 1991, the Peso has appreciated around 8% against the US$ (Chart 7), with over half of this rise occurring during early 1992. This has all but unwound the October 1990 devaluation. The Peso has appreciated due to (1) the imposition of the import levy which has choked off the demand for foreign exchange, and (2) an inflow of short term capital which has been pouring into the economy to speculate on the currency's level, and to take advantage of the wide Peso/US$ interest rate differential. This inflow has made reserve money management difficult and has compelled the authorities to issue additional treasury bills, thus forcing down interest rates even further (Chart 7). T-bill rates have fallen from almost 30% at the end of 1990 to 14%. Nevertheless, the downside on interest rates is probably limited from here. The lifting of the import levy, foreign exchange liberalisations introduced in January 1992 which allow easier trade financing, and a rebound in economic activity, all point towards a resurgence in import growth (Chart 6) and thus a deterioration in the external accounts (Chart 5). This in turn implies a depreciation in the overvalued Peso which could see a reversal of short term capital inflows and thus central bank intervention to prevent a sharp sell-off. However, given the now healthy level of foreign exchange reserves, an explicit devaluation should not be necessary.

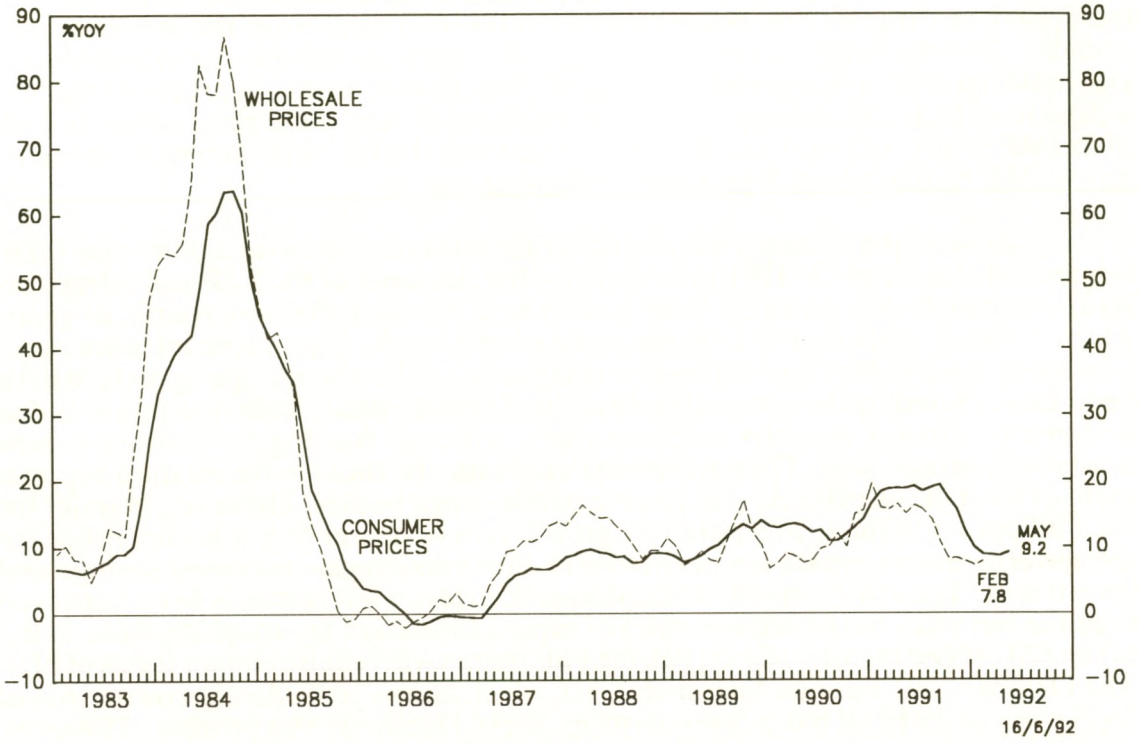
THE PHILIPPINES: CHART 9
GROWTH OF M2 AND RESERVE MONEY



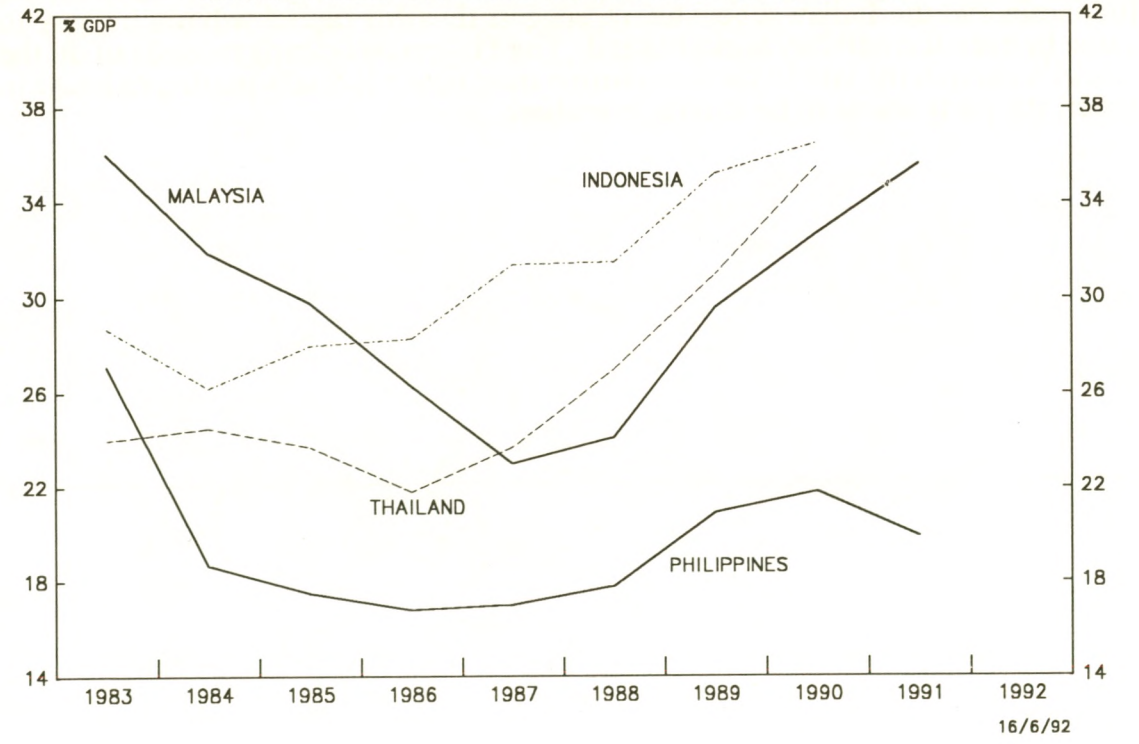
THE PHILIPPINES: CHART 10
GROWTH OF M2 AND BANK LOANS TO PRIVATE SECTOR



THE PHILIPPINES: CHART 11
INFLATION



THE PHILIPPINES: CHART 12
GROSS FIXED CAPITAL FORMATION AS % OF GDP



SUMMARY AND CONCLUSION: The turnaround in the fortunes of the economy of the Philippines, and the conversion of the authorities to sound economic management, has been little short of remarkable given the woeful record of the previous three decades. The challenge for the new Ramos administration will now be to consolidate and build upon the achievements of Aquino's last year in power, in order to engineer a climate of high and stable growth. The economy should come close to meeting all of its IMF targets this year and it is to be hoped that the ESP will then be replaced by a new IMF medium term 5-year economic programme.

Although the economy has clearly turned and is now growing again -- real GDP rebounded sharply in Q4 1991 to 3.6% yoy -- the demands of the ESP and infrastructural constraints will probably limit growth to 2-3% over the next couple of years, which is barely sufficient to outstrip population growth. The major infrastructural constraint remains the chronic power shortages that afflict the archipelago which have been exacerbated by the continuing drought. Unfortunately, little new power is due to come on stream over the next two years, although funding for projects is now available from agencies. The government's tight fiscal stance has meant the postponement of most of the projects that involve public sector bodies. However, in order for the Philippines to move to a potential growth rate of nearer 6%, it is imperative for the government to create an environment that encourages increased savings and investment. The environment for the domestic investor has certainly been improved over the last year, but to achieve rates of capital formation approaching those in the other ASEAN economies (Chart 12), the Philippines will require similar levels of FDI. The October 1991 Foreign Investment Act, which allows 100% foreign ownership of local companies in all but a few industries, should facilitate this process. However, establishing international credibility and thus attracting large scale private capital inflows is likely to take some time. Furthermore, the current retrenchment of Japanese investment, and alternative opportunities presenting themselves in China, Indonesia and the Indian subcontinent, suggest that this capital will not be easy to come by even if credibility is established. The Philippines clearly missed out on the ASEAN party in the late 1980s but unfortunately, now it is finally putting its house in order, the party seems to be moving elsewhere.

BOOK REVIEW
"ECONOMICS FOR PROFESSIONAL INVESTORS" - by Tim J. Lee published by Woodhead-Faulkner, 1992.

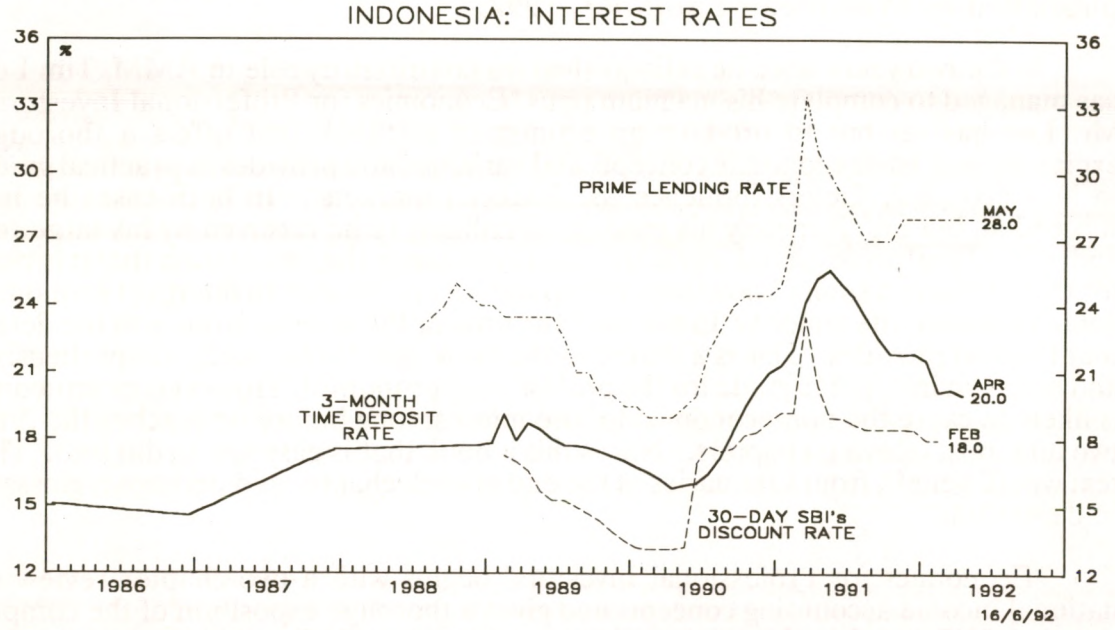
In the two years since he relinquished his contributory role to AMM, Tim Lee has managed to complete his magnum opus "Economics for Professional Investors". Mr. Lee has set out to produce an economics textbook that offers a thorough explanation of basic economic concepts and variables and provides "a practical guide to how economic factors influence the financial markets". In both cases he has succeeded, but unfortunately his message is unlikely to be received by his targetted audience. Few "professional investors" would challenge the assumption that it is vital for them to have a sound knowledge of economics and be able to interpret economic data. However, the majority do not have the time or the interest to go into the detail that this text provides. This is a shame as the book is well-reasoned, comprehensive and offers an invaluable guide for the professional economist. However, its structure is likely to cause the non-economist to lose interest long before he reaches the final two and most relevant chapters. Nor is this a book that is easy just to dip into. The text would benefit from summaries at the end of each chapter and perhaps a glossary of definitions.

"Economics for Professional Investors" begins with a two chapter review of national income accounting concepts and gives a thorough exposition of the components of GNP and the other national income measures. GNP is initially explained in terms of its expenditure components but a reconciliation of the output and income measures is subsequently included. Chapter 3 then develops a flow of funds analysis using a sectoral balance sheet approach and explains the interaction between domestic and external savings and investment. The next chapter explains the meaning and composition of the balance of payments and highlights the differences in the accounts of different countries. A discussion of the spot and forward currency markets is also included. The next five chapters utilise the concepts developed earlier in the text to explain how various economic variables behave and interact in practice, and how their behaviour impacts on financial markets. The role of liquidity, interest rates and exchange rates, from a monetarist perspective, is given great emphasis, and subjects discussed include commodity standards, managed exchange rates, and the European Monetary System and European Monetary Union. Chapter 10 is devoted to the relationship between the economy and the stock market, and is the nearest we get to an insider's guide to how G.T. conducts its economic research. The most common model of stock market valuation is developed and there then follows a discussion of stock market behaviour under different economic circumstances. Finally, chapter 11 concludes with a discussion of the specific difficulties encountered when analysing economic data.

Throughout, the text is illustrated with real world examples from the United States, Europe and Asia, that serve to augment and emphasise the author's theoretical arguments. This adds greatly to the accessibility of the work, but if anything, the technique is underutilised, especially in the key chapter covering economic influences on financial markets.

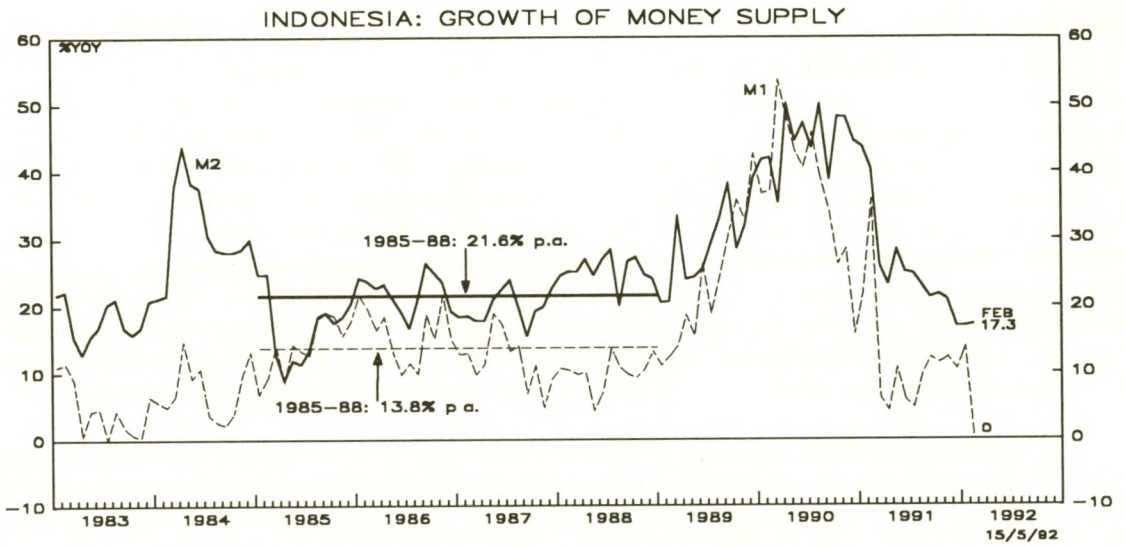
Overall, "Economics for Professional Investors" is to be highly recommended for anyone seeking to improve their understanding of the relationship between economics and the financial markets. The book is not for the individual seeking a "user-friendly" guide to the subject, but it is a must for the professional who has the patience and the genuine wish to explore the subject in detail.

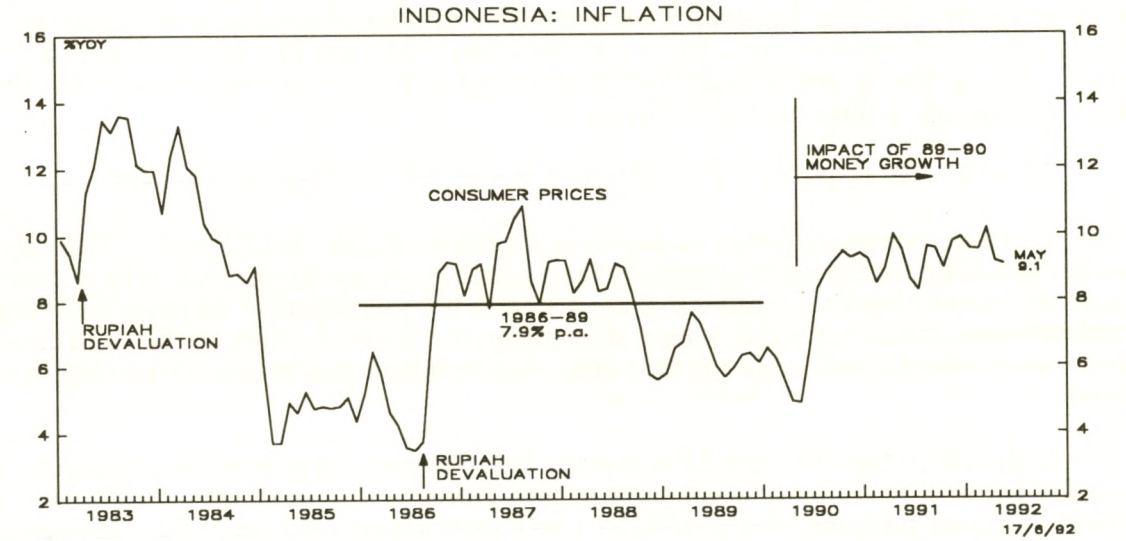
INDONESIA: A LOOSER MONETARY POLICY BUT THE BANKS REFUSE TO LEND

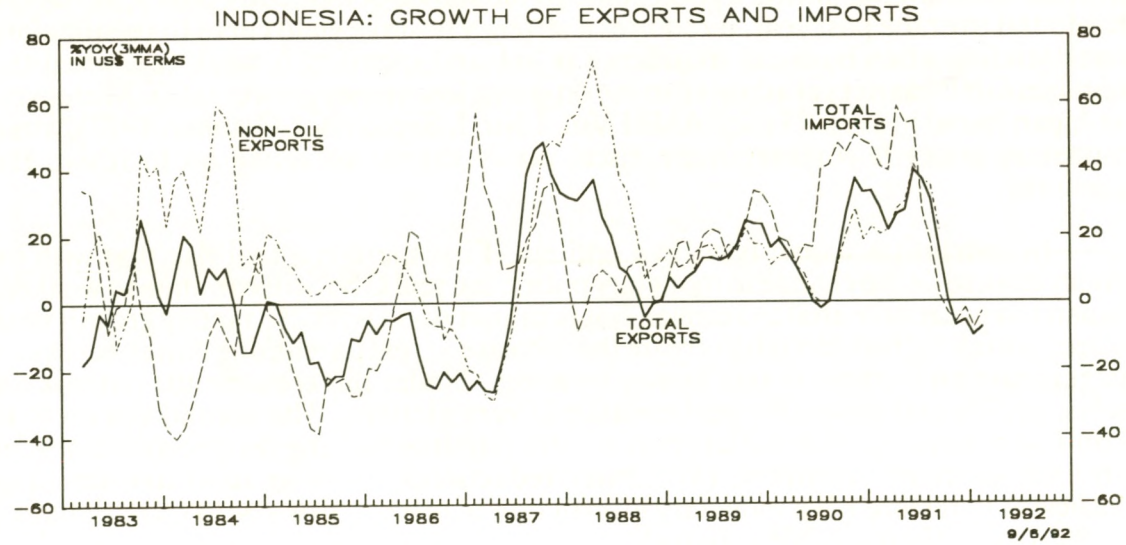


Despite moves by Bank Indonesia (BI) to push down interest rates and stimulate bank lending, lending rates have remained stubbornly high. BI bills or SBIs are now yielding 500 basis points less than in February 1991, when the "Sumarlin Shock" caused rates to spike up sharply in order to slow an overheating economy. Furthermore, the authorities have been openly stating that they wish to see banks expand their loan books in order to re-stimulate economic activity. However, banks have been less than obliging and although deposit rates have come down in line with SBI yields, lending rates have barely moved. The reason is that the banking system is extremely fragile and riddled with bad loans as a result of the credit blow-out which followed financial deregulation in 1988. Banks are therefore attempting to keep margins as wide as possible and are restricting new loans as they attempt to meet a range of prudential regulations introduced this year. These regulations include a target capital adequacy ratio of 5% (rising to 7% by March 1993, and to 8% by December 1993), a maximum loan/deposit ratio of 110% by 1993, directives to give 20% of loans to small-scale enterprises and, in the case of the foreign exchange banks, 80% to export credits. With the carnage in the loan books now surfacing, it is understandable that many institutions are struggling to meet these requirements and are therefore using various methods to skirt the regulations. BI is turning a blind eye as long as the cheating is not too overt. The impression given is that these regulations will be enforced more strictly in the long run when the worst of the problems are passed, but for the present, getting the economy moving is the prime objective. One measure being considered is to allow the revaluation of fixed assets to count as tier II capital. This would help considerably as land appears in the books at purchase value.

Apart from the banking sector and those companies that are heavily geared, the real economy is surprisingly buoyant and loan demand remains robust even if the supply is not forthcoming. High interest rates have caused money growth to fall into BI's 15-20% target range, and as a result inflationary pressures have moderated. However, non-oil export growth has held up well and foreign direct investment inflows -- in sharp contrast to Thailand and Malaysia -- remain strong.


INDONESIA: GROWTH OF MONEY SUPPLY
%YOY
M1
M2
1985–88: 21.6% p.a.
1985–88: 13.8% p.a.
FEB
17.3
0
1983
1984
1985
1986
1987
1988
1989
1990
1991
1992
15/5/92


INDONESIA: INFLATION
%YOY
IMPACT OF 89–90
MONEY GROWTH
CONSUMER PRICES
MAY
9.1
1986–89
7.9% p.a.
RUPIAH
DEVALUATION
RUPIAH
DEVALUATION
1983
1984
1985
1986
1987
1988
1989
1990
1991
1992
17/6/92


INDONESIA: GROWTH OF EXPORTS AND IMPORTS
%YOY(3MMA)
IN US$ TERMS
NON–OIL
EXPORTS
TOTAL
IMPORTS
TOTAL
EXPORTS
1983
1984
1985
1986
1987
1988
1989
1990
1991
1992
9/6/92

JAPAN: PRECONDITIONS FOR AN ECONOMIC RECOVERY.

Since mid-1990 BOJ Governor Mieno has enforced an extremely tight money, with record low growth rates of M2+CDs with the intention of bursting the "asset bubble" of the late 1980s. Initially in 1990H2 and 1991H1 there was not much impact on real GNP because the high level of liquidity (M2+CDs) relative to spending (nominal GNP) in the economy meant that the time lag between money and GNP was longer than normal. However, in the past year velocity has risen, or, conversely Marshall k, the ratio of money to GNP has fallen sharply (see top panel opposite). As predicted in a past issue of AMM (Vol.15 No. 4, July-August 1991) nominal GNP is now slowing in line with the restricted money growth, causing Marshall k to fall back below its trend line roughly following time path (A). Does this mean the adjustment is completed and the economy can now return to its equilibrium growth path?

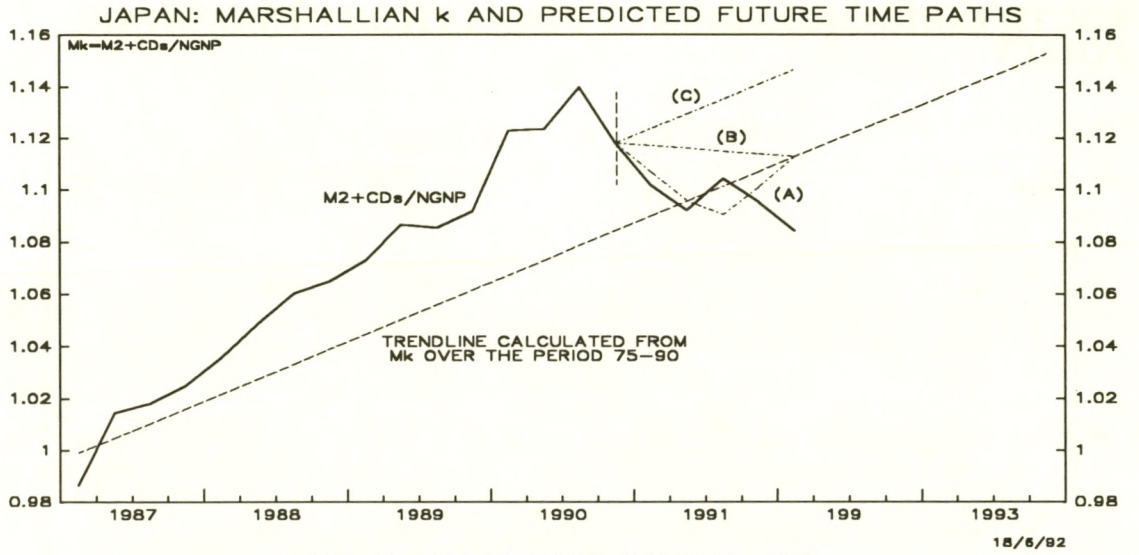
Unfortunately not. Assuming there is no change in the money growth rate -- i.e. M2+CDs continues at roughly 2% p.a. -- the economy will not resume its normal or full potential growth path until the GNP deflator is falling at about 4% p.a.. This is so because Japan's potential real growth rate is about 4% p.a. (the economy grew at an average of 4.3% p.a. between 1980 and 1990), and income velocity in Japan has a trend rate of growth of minus 2.5% p.a. (alternatively Marshall k rises at roughly 2.5% p.a.). Using the quantity equation, and plugging in 2% for money growth, the following result is obtained for inflation :-

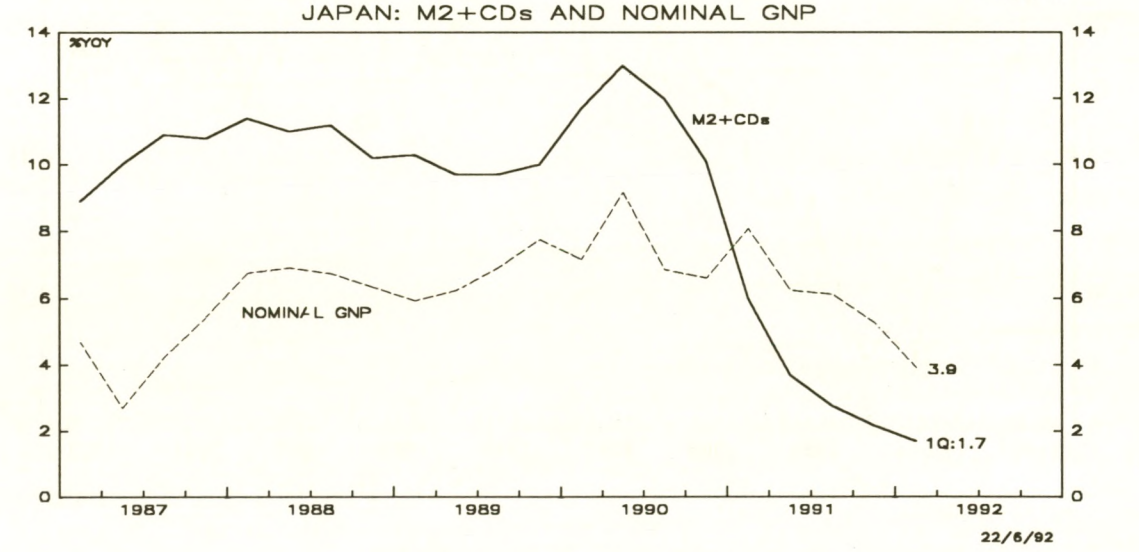
$$M + V = P + Y \quad \text{or} \quad P = M + V - Y \quad = \quad 2 + (-2.5) - 4.3 = -4.8$$

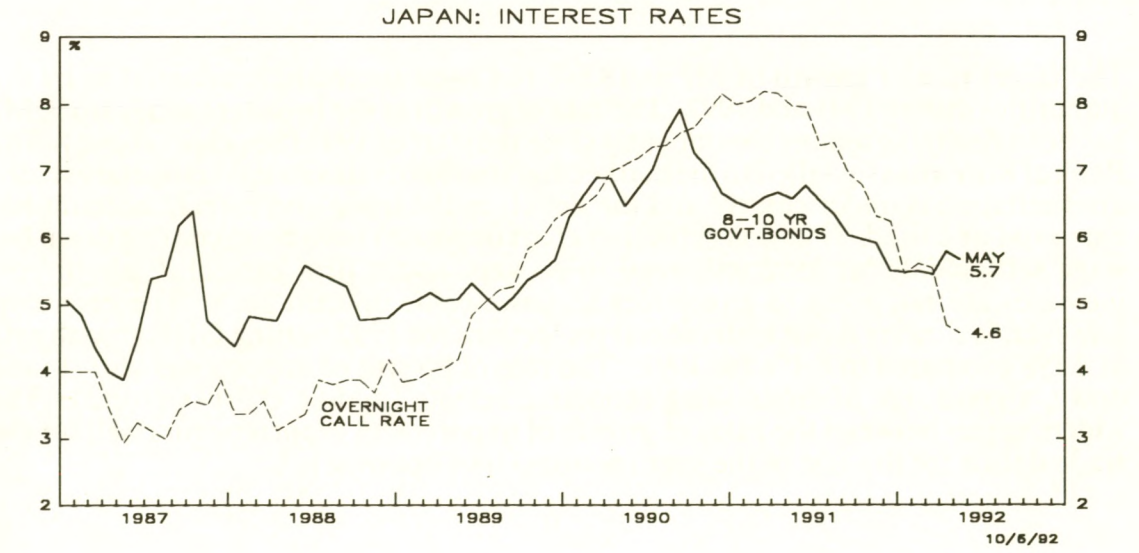
Current monetary policy in Japan is therefore highly deflationary. The right policy would be to aim for price stability and hence for monetary growth to be allowed to re-accelerate back to about 6% p.a.. This is a precondition for an early recovery, and will require further reductions in short term interest rates, shifting the yield curve to a more strongly positive slope, thus encouraging businesses to borrow and banks to lend.

Officials at the BOJ, the EPA and the MOF argue that policy has already been eased. Interest rates have fallen substantially from their peaks and a Yen 4 trillion fiscal stimulus package (0.9% of GNP) was announced on March 31. However, interest rates are not always a good guide to the stance of monetary policy; as the US has found over the past year, it requires a strongly positive yield curve to re-stimulate bank lending when business confidence is low and spending is weak (i.e. when the nominal GNP has not yet adjusted to the on-going low money growth rate). Moreover, as Japan found in 1976-77 (See AMM Vol. 1 No. 1, September-October, 1977), when monetary policy is contractionary, fiscal policy cannot be relied on to revive the economy.

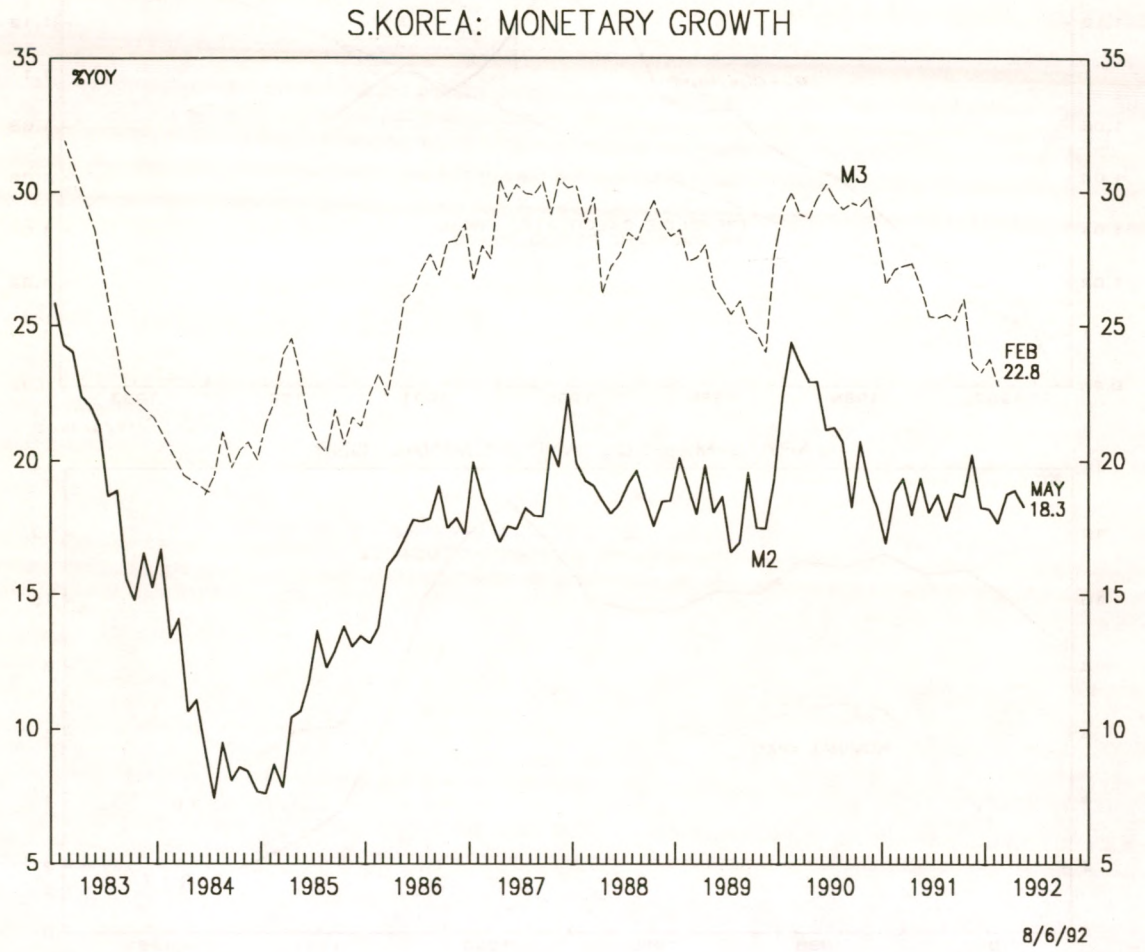
In conclusion, Japan faces two options. First there is a real risk that with no policy change i.e. no change in monetary policy, the real GNP will continue to weaken. Japan has great potential to recover, but it cannot do so with 2% money growth until prices are falling fast enough to create the increase in real purchasing power necessary to generate an increase in real money balances. Under this scenario the outlook for sales, profits and economic performance is very gloomy. The second option is to implement a change in monetary policy. This requires meeting two preconditions for an early economic recovery: (1) further reduction(s) in short term interest rates sufficient to restore (2) a monetary growth rate of 6% p.a. (for a zero GNP deflator) or 8% (for a 2% p.a. GNP deflator).


JAPAN: MARSHALLIAN k AND PREDICTED FUTURE TIME PATHS
Mk=M2+CDs/NGNP
(C)
(B)
(A)
M2+CDs/NGNP
TRENDLINE CALCULATED FROM
Mk OVER THE PERIOD 75–90
1.16
1.14
1.12
1.1
1.08
1.06
1.04
1.02
1
0.98
1987
1988
1989
1990
1991
199
1993
18/6/92

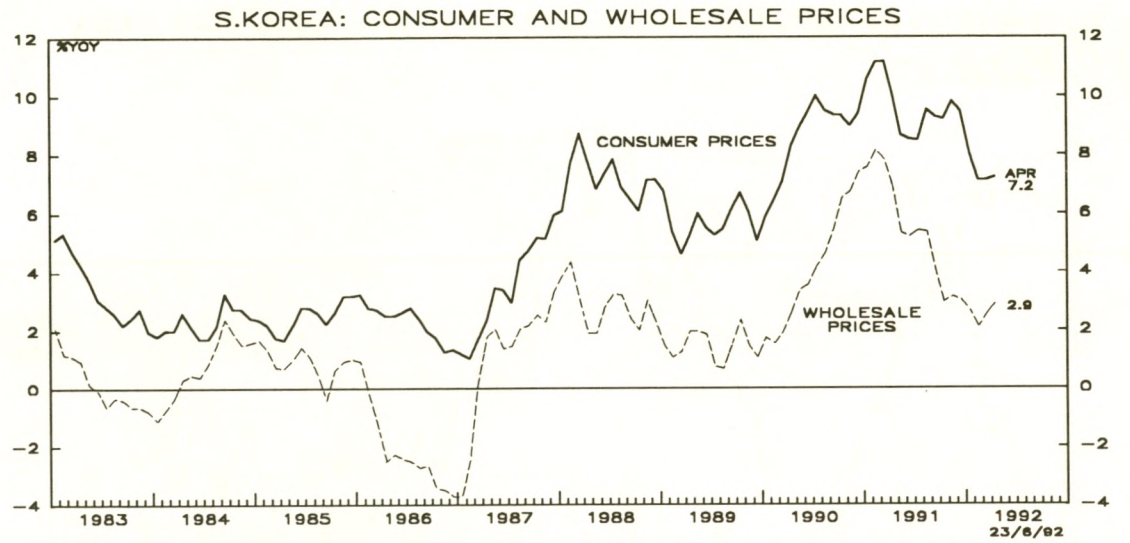

JAPAN: M2+CDs AND NOMINAL GNP
%YOY
M2+CDs
NOMINAL GNP
3.9
1Q:1.7
14
12
10
8
6
4
2
0
1987
1988
1989
1990
1991
1992
22/6/92

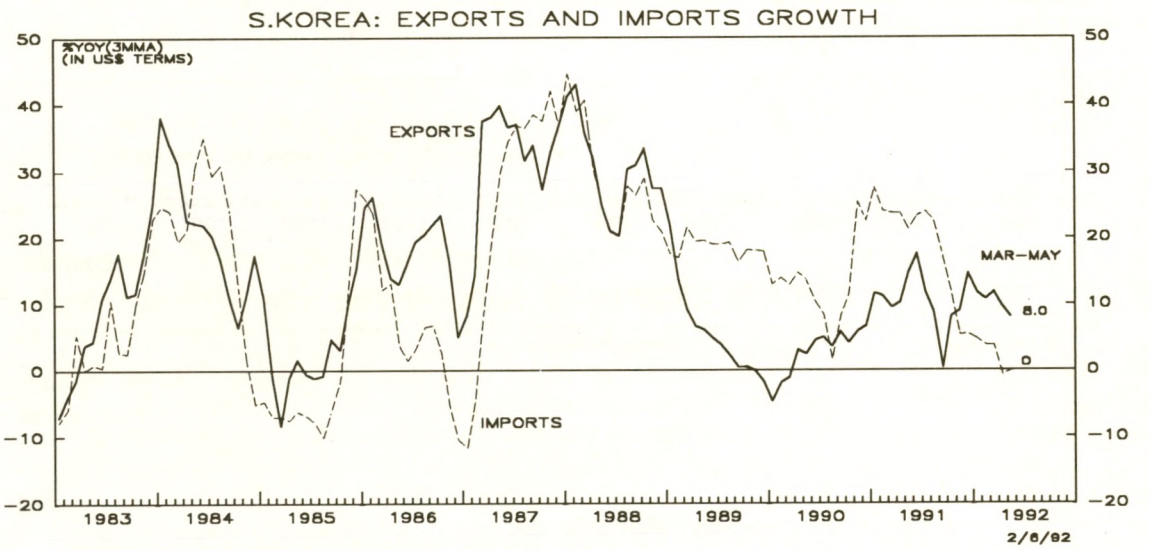

JAPAN: INTEREST RATES
%
8–10 YR
GOVT.BONDS
MAY
5.7
4.6
OVERNIGHT
CALL RATE
9
8
7
6
5
4
3
2
1987
1988
1989
1990
1991
1992
10/6/92

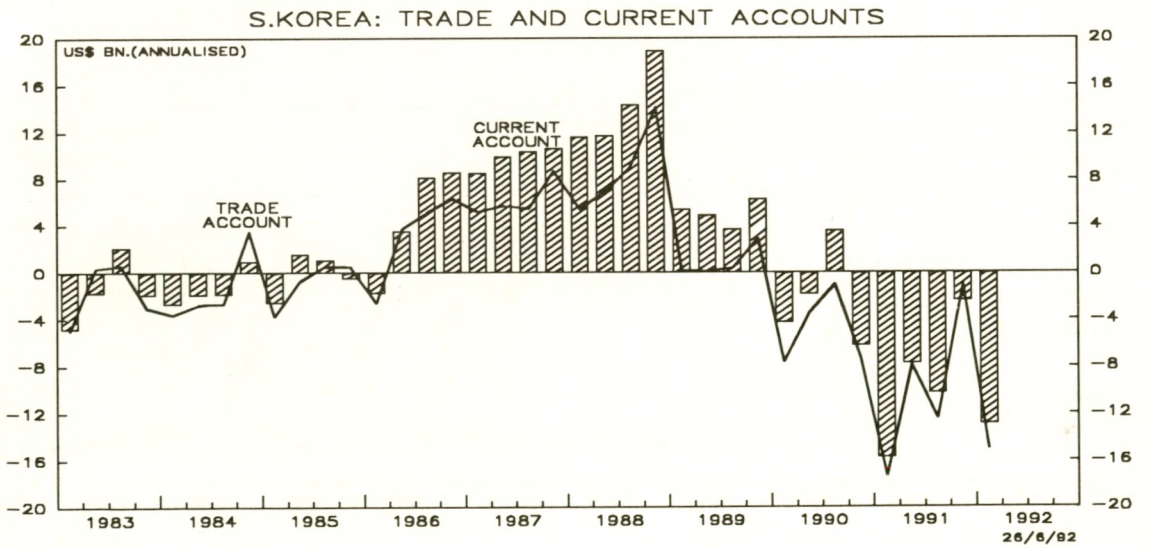
SOUTH KOREA: NO SIGNS OF RELAXATION IN MONETARY POLICY



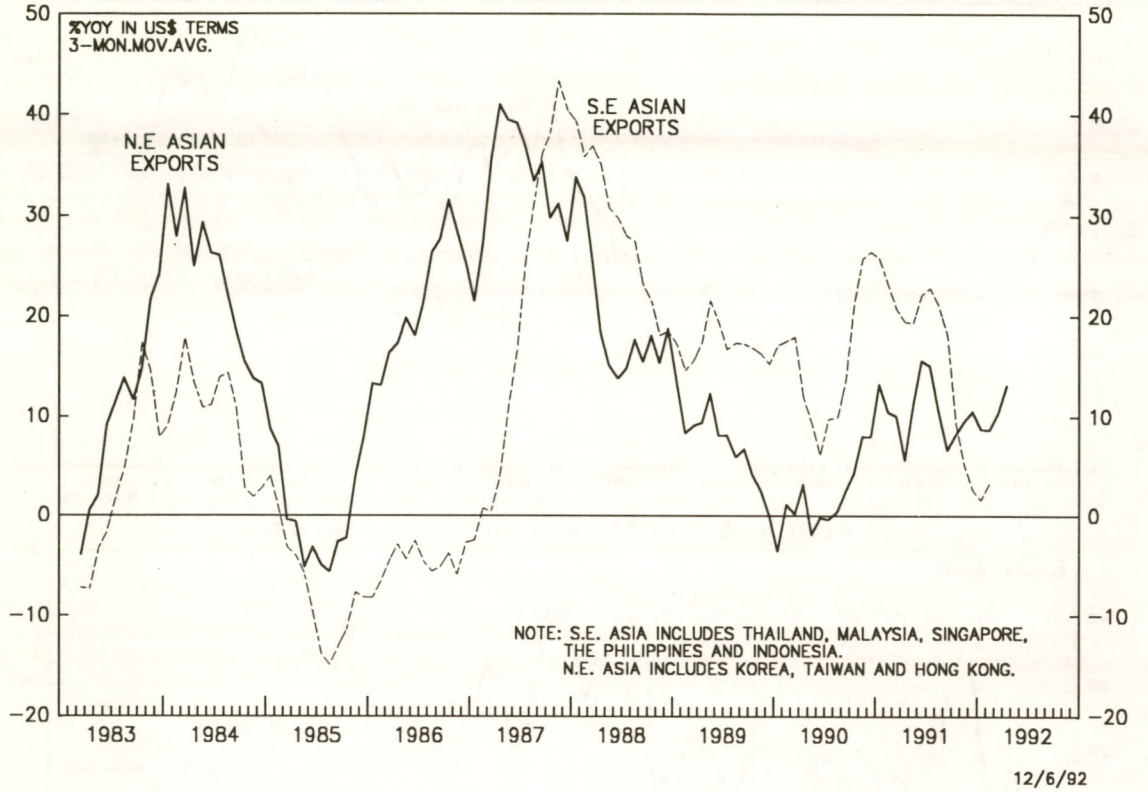
The target rate of growth of M2 at 18.5% has been successfully adhered to by the authorities during 1991 and 1992. The rate of growth of the broader money stock M3 has been declining almost continuously since the start of 1991 (See chart above). The Bank of Korea has signalled to the market that it will not relax its tight monetary stance until inflation is under control and the deficit in the trade and current account has narrowed or closed. Inflation rates (top chart opposite) have been coming down but wage settlements for 1992 will need to be kept under firm control if labour cost increases are not going to give prices an unwelcome upward push. The economy, however, is slowing down with official projections for 1992 putting GDP growth rate at 7.3% compared to 8.4% for 1991. The rate of growth of imports has also slowed down, a good sign of diminishing economic activity (middle chart opposite). The widening gap between the rates of growth of imports and exports augurs well for the trade deficit for the rest of the year (bottom chart opposite).


S.KOREA: CONSUMER AND WHOLESALE PRICES
%YOY
CONSUMER PRICES
APR
7.2
WHOLESALE
PRICES
2.9
1983
1984
1985
1986
1987
1988
1989
1990
1991
1992
23/6/92

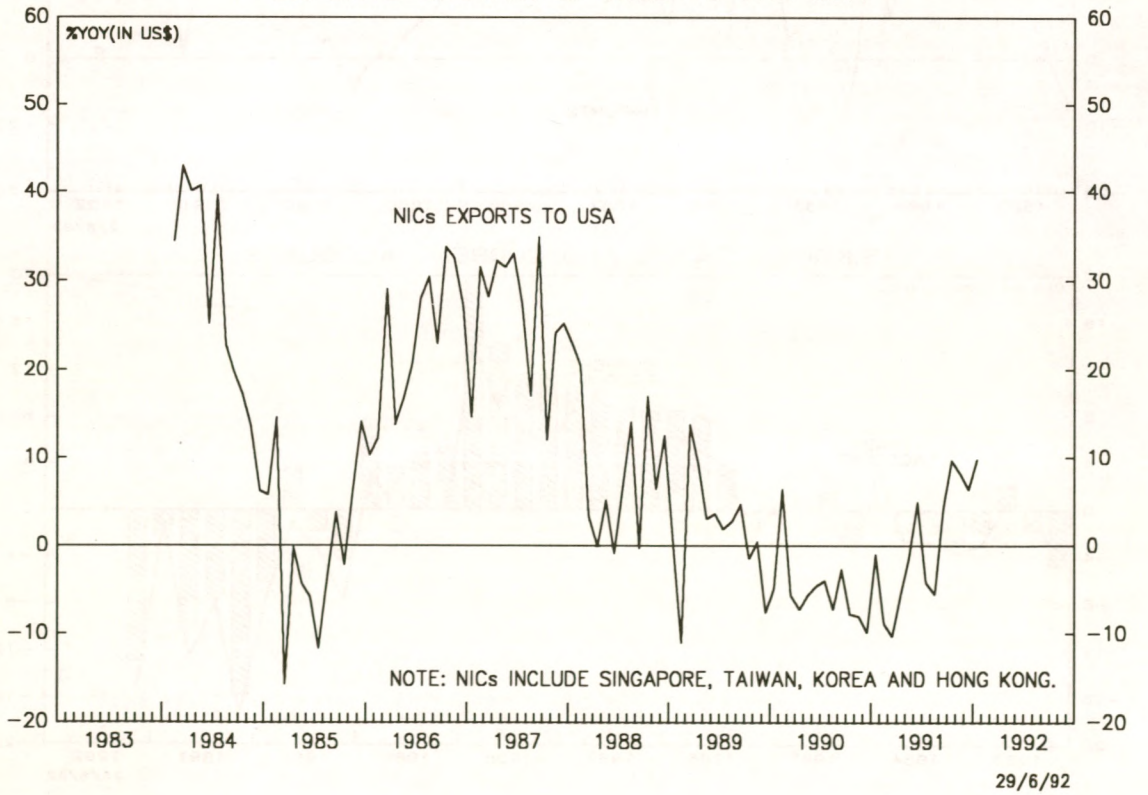

S.KOREA: EXPORTS AND IMPORTS GROWTH
%YOY(3MMA)
(IN US$ TERMS)
EXPORTS
IMPORTS
MAR-MAY
8.0
0
1983
1984
1985
1986
1987
1988
1989
1990
1991
1992
2/6/92


S.KOREA: TRADE AND CURRENT ACCOUNTS
US$ BN.(ANNUALISED)
CURRENT
ACCOUNT
TRADE
ACCOUNT
1983
1984
1985
1986
1987
1988
1989
1990
1991
1992
26/6/92

GROWTH OF EXPORTS OF N.E ASIAN AND S.E. ASIAN ECONOMIES



EXPORTS GROWTH OF NICs TO THE USA



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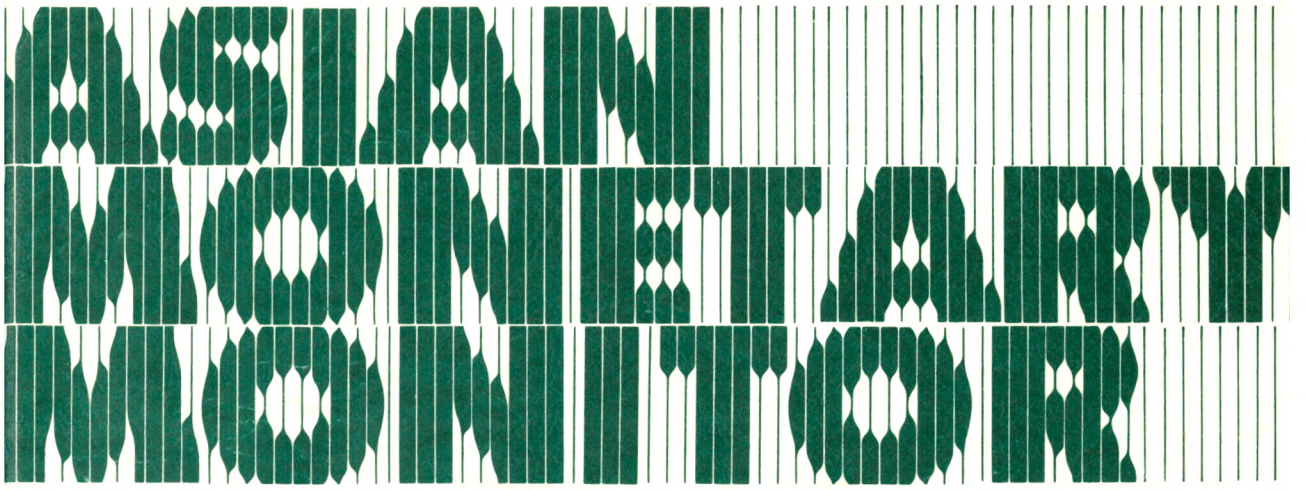

CONTENTS

		Page
HONG KONG		
Direct and Portfolio Investment Flows to and from China by Andrew Freris		1
TAIWAN		
Factors Preventing the Next Asset Price Explosion by Simon Ogus		12
TURKEY		
A Danger of Hyperinflation by Tim Lee		22
ECONOMIC CAPSULE		
China: A Third Episode of Go-Stop	JGG	32

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ASIAN MONETARY MONITOR

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HONG KONG: DIRECT AND PORTFOLIO INVESTMENT FLOWS TO AND FROM CHINA

Introduction

Two previous articles in this journal explored various aspects of the trade links between Hong Kong and China (Vol. 15 No. 5, Sept.-Oct. 1991, Vol. 16 No. 3 May-June 1992). The main conclusions drawn were that the rapid growth of the re-export trade with China represented another aspect of the importance of the US in the economies of both Hong Kong and China. Directly or indirectly the US still remains the single most important export market for Hong Kong. The so-called Outward Processing trade component of both domestic exports and re-exports reflects the importance to Hong Kong of the competitive advantages offered by the cheap labour and land available across the border and thus explains the migration of Hong Kong's manufacturing base there. The analysis and examination of Outward Processing-related trade allows a quantification of the manufacturing links established with China as this trade relates to the processing of goods in China and their eventual exportation to, or re-exportation from Hong Kong.

An important business cycle-connected aspect of these developments is that China remains a relatively small market for the exports of Hong Kong compared to the US. Furthermore, cyclical movements in Hong Kong's economy are still linked to those of the US rather than those of China. Cyclical downturns in China will affect the economy of Hong Kong only to the extent that they would influence negatively the activities of the industries which have migrated there and, by extension, the re-export trade which they support.

This article explores a related theme to these developments, that of the flows of direct and portfolio investment between the two economies. It is a well known proposition that "trade follows investment". In the case of Hong Kong's investment in China, there is the added dimension of the enormous potential of the Chinese domestic market. This, however, is a long term proposition in view of the still very low per capita income in China, US$318 in 1991 compared to Hong Kong's US$14,000.

The article makes use of the most up-to-date statistical information available from both Chinese and Hong Kong sources. In some cases data are available only up to 1990 but they offer sufficient indications on trends as to allow for reasonably accurate observations as to future movements and developments.

Chinese Direct Investment in Hong Kong

In 1985 the Industry Department of Hong Kong started to collect systematic statistics on Chinese direct investment in Hong Kong's manufacturing sector. The survey, in general, covers:

"the direct investment by overseas investors ..... of another country through equity holdings. The investment usually entails control over management or participation in

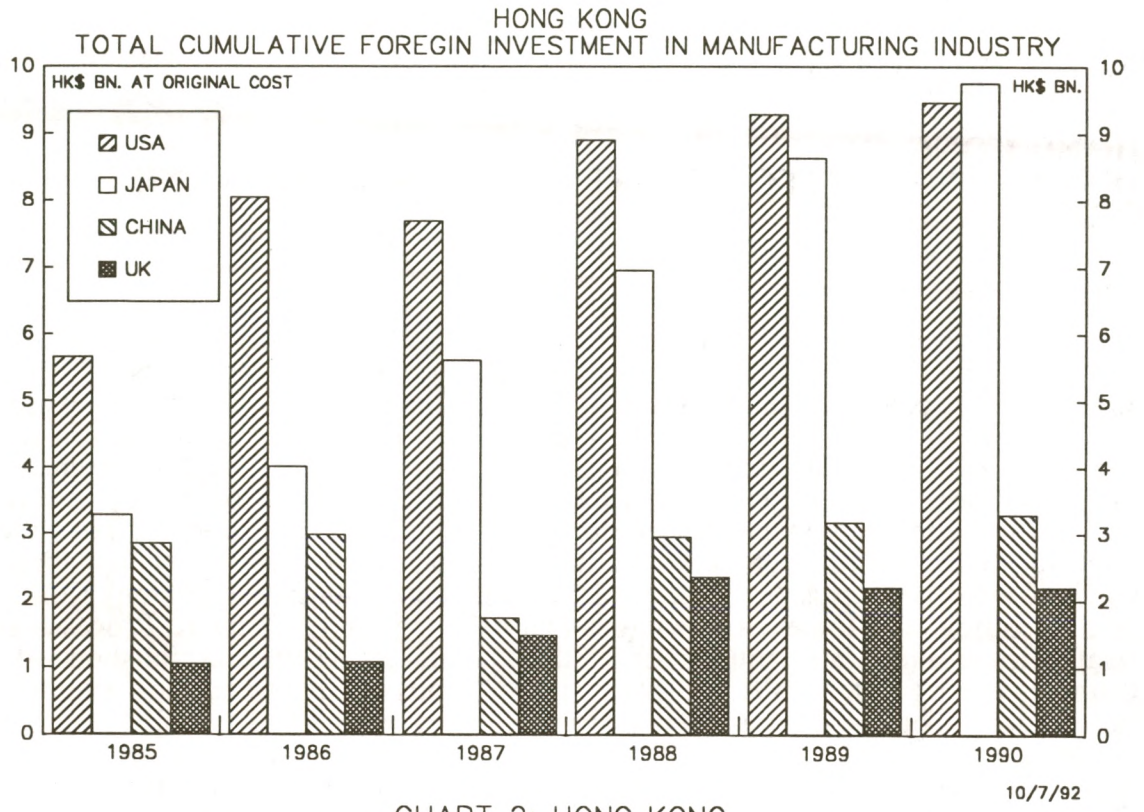
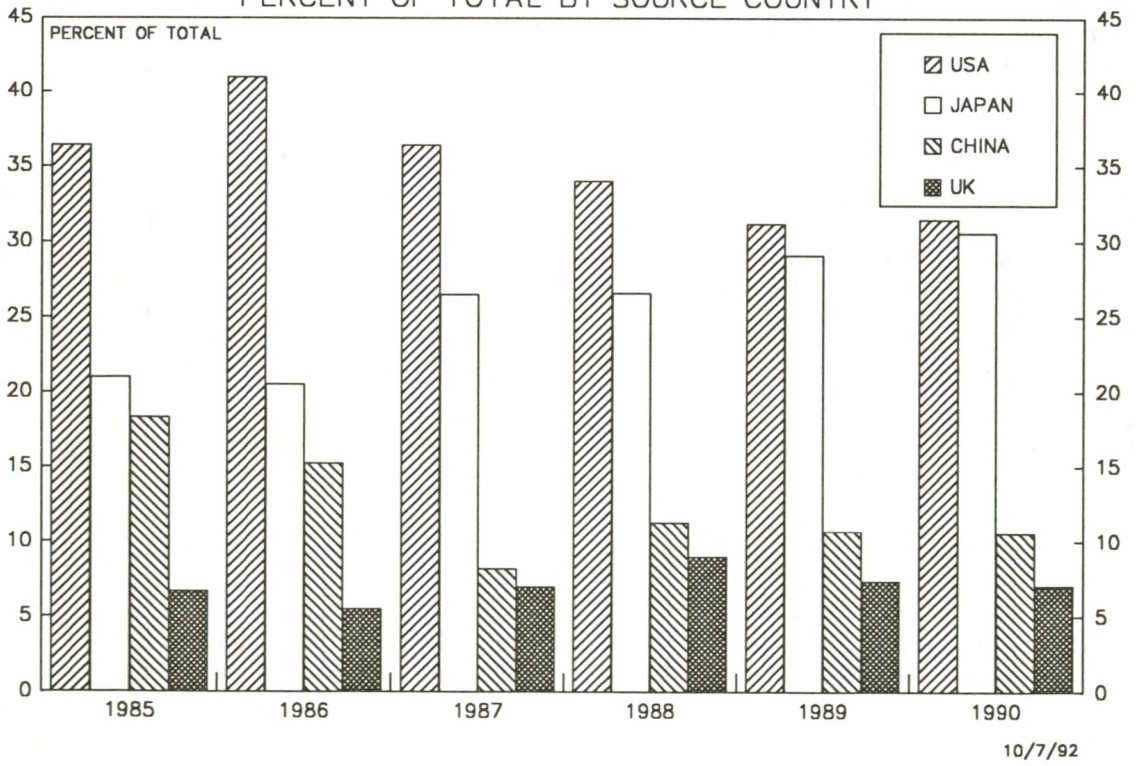


CHART 2: HONG KONG
CUMULATIVE FOREIGN INVESTMENT IN HONG KONG
PERCENT OF TOTAL BY SOURCE COUNTRY



management .... Total investment at original cost refers to the value of the stock of fixed assets at original cost plus working capital at the end of the reporting period".

(Official definitions from the Annual Report of the Survey of Overseas Investment in Hong Kong Manufacturing Industries, Industry Department, various years.)

The investment expenditures data used in the analysis are measured at original cost in order to avoid the complications of having to allow for depreciation and inflation. Comparisons across countries and different time periods are thus consistent, although the absolute sums reported may not be an accurate reflection of the relative importance of the capital invested to Hong Kong's total capital stock.

In order to evaluate the role of Chinese investment to Hong Kong it is necessary to compare it with other major direct investors. This is done in Charts 1 and 2 which show the sum totals invested and the percentage accounted by the top four countries in the survey.

The data in Chart 1 are cumulative totals, in other words they show the original cost valuation of investment undertaken by the country in question over a period of time, rather than the expenditures in any single year. The annual investment expenditures are shown separately in Chart 3. The statistics of the Industry Department of Hong Kong cover periods separated into "Pre-1970" as a total aggregate, and "post-1970" on a yearly basis. As indicated, annual data for China exist from 1985 onwards although the Department does offer estimates for the pre-1970 period. For any single year the Department calculates the gross additions to fixed assets. This sum is then used to calculate the cumulative stock of fixed assets at original cost, to which working capital is added to give total (cumulative) foreign investment.

As Charts 1 and 2 indicate US and Japan remain the two top foreign investors in Hong Kong with China a distant third. What is important, however, is that the reduction in China's share of the total between 1985-87 was partially reversed during 1988-90, a period of declining GDP growth rates in China and of tight fiscal and monetary policies. China's relative position must also be appraised against the fact that China's involvement in Hong Kong's industry before 1980 was minimal. In contrast to UK, which has had a long involvement with the territory, Chinese investment came effectively from nowhere to rank consistently as the third largest foreign participant in Hong Kong's industry.

Chart 3 shows the annual additions to fixed assets and Chart 4 shows the percent share of each of the four countries to the total of these annual additions. China's position slipped during 1989-90 as the austerity measures of 1989 took effect.

Chart 5 shows that foreign investment in Hong Kong is concentrated primarily in the electronics and electrical sectors and secondarily in textiles and clothing. Chart 6 shows the distribution of Chinese investment in Hong Kong's industries which varies significantly from that of the aggregate foreign investment (including that of China) as shown in Chart 5. This is not surprising because, as will be shown later on, the main thrust of Hong Kong's investment in the manufacturing sector in China has been in the textiles and electronics sectors. It would have been, therefore, rather odd if China invested in similar facilities in Hong Kong, given that comparative, and absolute, advantages in these areas rest mostly with China.

CHART 3: HONG KONG
FOREIGN INVESTMENT: GROSS ADDITIONS
TO FIXED ASSETS BY COUNTRY OF ORIGIN

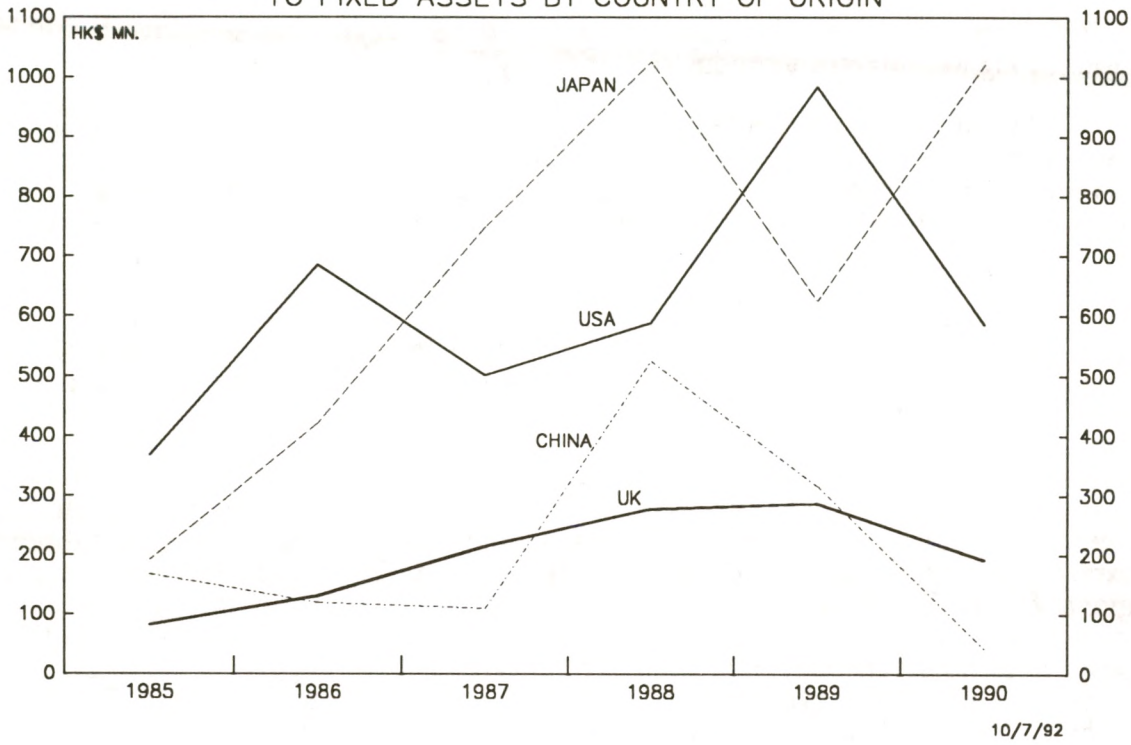
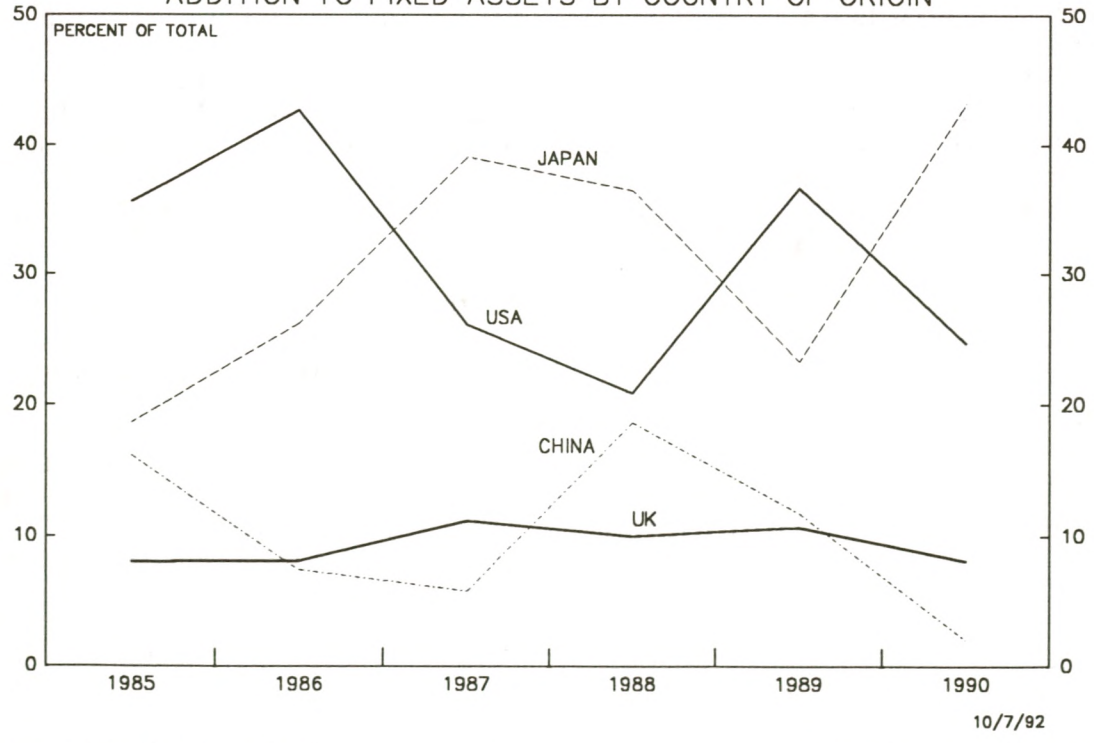


CHART 4: HONG KONG
FOREIGN INVESTMENT: PERCENTAGE OF GROSS
ADDITION TO FIXED ASSETS BY COUNTRY OF ORIGIN



For the sake of a complete record, data relating to investment overseas by China and released by Chinese authorities are exhibited in Chart 7. The original estimates are in US dollars which have been converted to HK dollars at the fixed HK$7.80 rate. These figures are, of course, not comparable to those of Chart 1. They are not cumulative and they refer to total outflows without any geographical or sectoral distribution. The original source used classified net bank loans, aid, trade credits and other assorted flows as long term capital. Here only the direct and portfolio investment outflow figures are given. It is interesting also to note that Chinese entities also make portfolio investments overseas. The overall trend, however, given the short time period covered by the sample, is not too different from that shown in Chart 3, with total outflows peaking in 1988.

The data, such as they are, simply indicate the relative importance of China in the overall flows of foreign investment in Hong Kong's manufacturing sector without revealing any specific trends or showing any particularly preferred area. It must be remembered, however, that these flows are only part of the overall commitment of China to Hong Kong's economy. In other words additional information is required to cover the rest of the sectors.

China's direct presence and investment in other areas of Hong Kong's economy is best illustrated by the activities of CITIC Pacific. This is a Hong Kong listed company used by China as its main instrument for direct participation in key sectors of the economy and for potential further expansion.

CHART 5: HONG KONG
DISTRIBUTION OF TOTAL FOREIGN INVESTMENT BY INDUSTRY

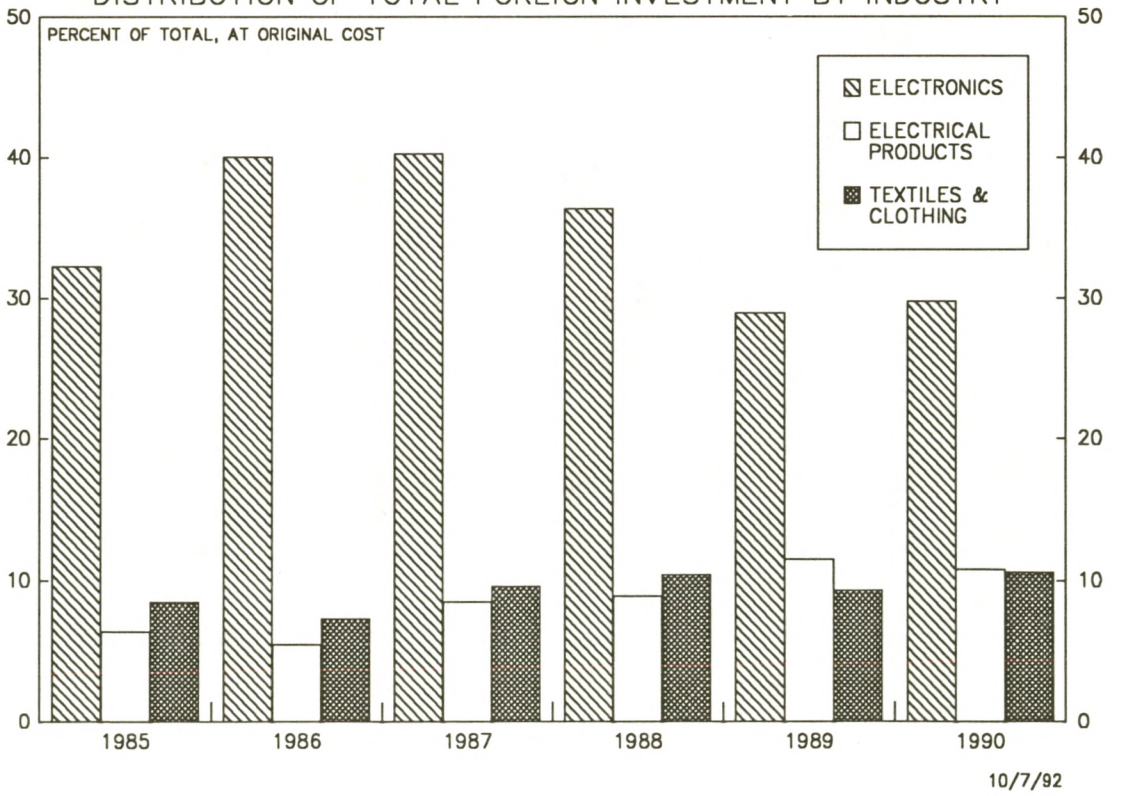
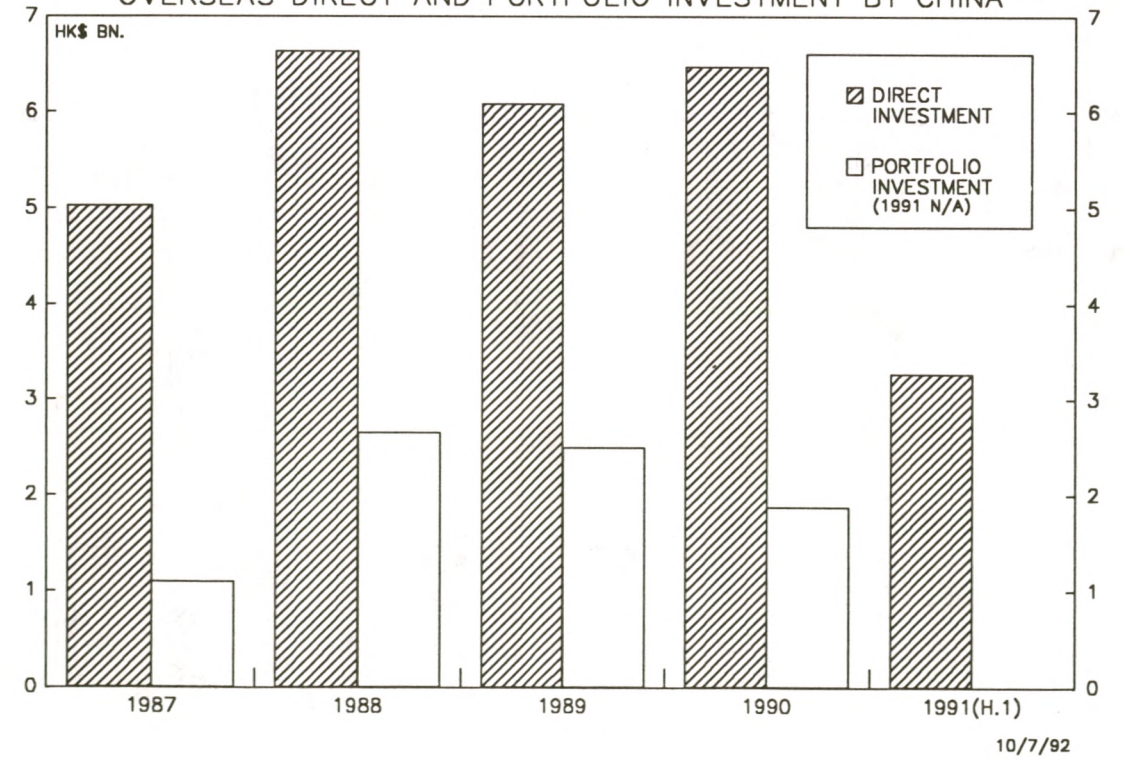


CHART 6:HONG KONG
SECTORAL ALLOCATION OF CHINESE INVESTMENT IN HONG KONG

CHART 7: CHINA
OVERSEAS DIRECT AND PORTFOLIO INVESTMENT BY CHINA



In 1979 the State Council of the PRC authorised the establishment of the China International Trust and Investment Corporation (Holdings), CITIC for short. The function of this body, which became China's de facto overseas investment bank, was to assist in China's modernisation and economic reform by importing advanced technology and taking part in domestic and international financing, banking etc. CITIC established a Hong Kong office in 1980. In 1990 CITIC (HK) acquired a 45% stake, in a listed Hong Kong company, Tylfull which was renamed CITIC Pacific. Through this company CITIC (HK), which is not listed in Hong Kong, acquired extensive interests in the following areas:

(a) Holdings of 12.5% in Cathay Pacific, Hong Kong's airline. Cathay is part of the Swire group of companies.

(b) Holdings of 46% in Dragonair, a smaller regional airline partly owned by Cathay Pacific

(c) Complete acquisition of Hang Chong whose main activities are car distribution, and property

(d) Substantial property and land holdings in various areas in Hong Kong

The company also holds 20% of the Telecommunications Company of Macau (CTM). CITIC (HK), and separately from CITIC Pacific, has a 24.5% share in the second Hong Kong cross harbour tunnel. Finally, and most importantly, it holds 20% of HK Telecom, the biggest listed Hong Kong Company. In addition to these holdings, two separate Chinese entities, the China National Aviation Corporation and China Travel Services, hold each 5% of the shares of Cathay Pacific, giving an aggregate total of nearly 22.5% of the airline in PRC hands. It is clear that the joint holdings of CITIC (HK) and Pacific represent a major commitment by China to Hong Kong's utilities, transport, property and trading sectors.

Finally, the Bank of China (BOC) group consisting of six locally incoporated banks plus another nine banks is now the single most important conglomerate outside the dominant Hongkong Bank and its subsidiaries. The credentials of this group, and of BOC in particular, are solid, including participation in bank rescues in Hong Kong and helping to bail out the stock index futures market in the October 1987 crash. The BOC is now certain to acquire the right to issue its own notes making it currently the third bank in the territory, other than the Hongkong and Standard Chartered Banks, to do so.(*)

Hong Kong Investment in China

As the authorities in Hong Kong do not collect data on the overseas capital transactions by Hong Kong residents, the evidence in this area is, by necessity, sketchy and has to be collated from diverse sources. Chart 8 summarises the information available from Chinese sources. It is clear that for the years covered, Hong Kong (and

(*) Formerly the Mercantile Bank used to issue HK$ banknotes, but after its absorption by HSBC (in 1959), its note issues were gradually retired.

obviously to a much lesser extent Macau which is added together with Hong Kong) accounted on average for over 60% of all direct investment in China. Some of these investment flows must be of Taiwanese origin in the sense that Taiwanese entities used Hong Kong as a base, or indeed as a "cover" in order to effect their investments in China. There are, however, at present no accurate estimates of these flows. Hong Kong is in other words the single most important foreign investor in China. An additional aspect of Hong Kong's importance is shown by the percentage of joint ventures registered in China during 1990 which are based in the territory. Of the total 495 joint ventures registered in 1990, 357 (or 72%) were of Hong Kong origin. Of these 357 joint ventures, 92 were located in Guangdong province, the rest elsewhere in China. The importance of Guangdong as the single most preferred location for foreign investors, and Hong Kong entrepreneurs in particular, is shown by the fact that during 1988, 1989 and 1990, the percentage share of the province to the total actual foreign direct investment in China stood at 30%, 34% and 42% respectively.

There are, unfortunately, no official statistics on the distribution, size, sectoral allocation etc. of Hong Kong's direct investment in China. The evidence is fragmented and sketchy at best. A first indication, however, of the sectoral allocation can be given by examining the structure of Hong Kong's domestic exports and particularly re-export trade with China. The reason for this is found in the development of the Outward Processing (OP) related flows of trade. (See AMM Vol. 16 No. 3 May-June 1992.) On average 76% of Hong Kong's domestic exports and 45% of re-exports with China involved OP activities (1988-1991). This meant that these exports were further processed in China and then were re-exported to Hong Kong. Since most of OP can be safely assumed to be undertaken by Hong Kong related enterprises in China, the structure of the exports will be indicative of the type of direct investment undertaken by Hong Kong enterprises. Table 1 outlines the data. Industries which are obvious targets for investment from Hong Kong include textiles, plastics and TV sets as these are destined primarily for exports as well as for domestic consumption and, hence, would involve OP activities.

CHART 8: CHINA
DIRECT INVESTMENT IN CHINA

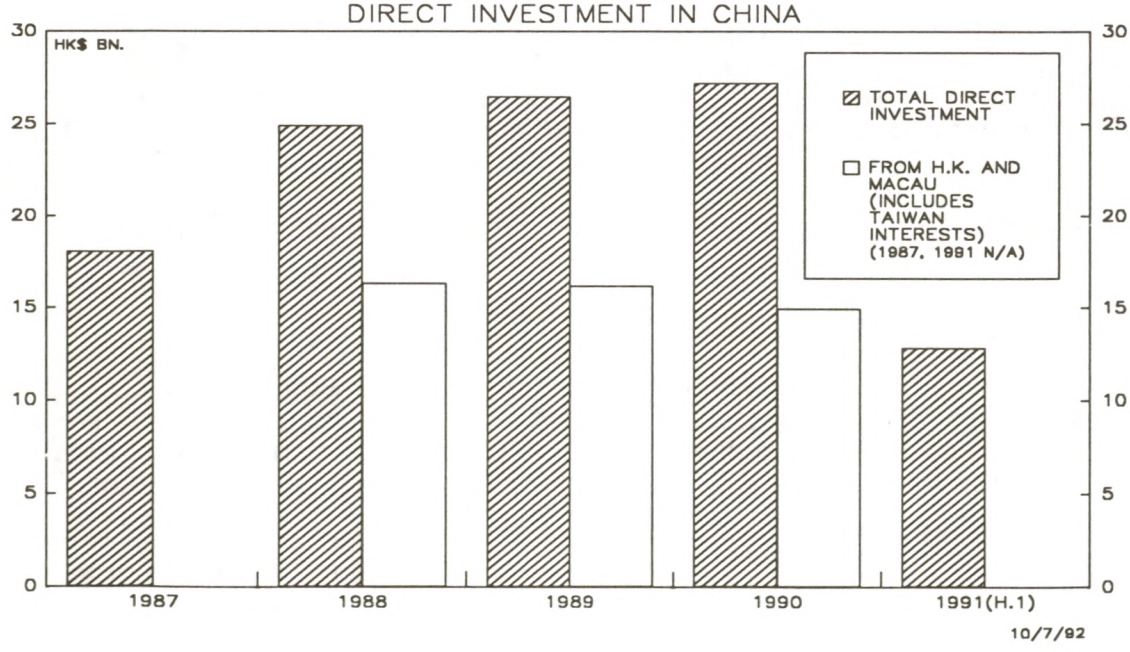


TABLE 1

HONG KONG: PRODUCT COMPOSITION OF EXPORT AND REEXPORT TRADE WITH CHINA (Figures in each category are percentages traded with China out of the total Hong Kong re-export and export trade)

	1985	1986	1987	1988	1989	1990	1991
REEXPORTS							
Textiles	60.0	56.0	52.3	53.5	55.3	59.9	61.1
TV and Related Equipment	31.8	13.7	16.9	27.3	28.8	32.6	27.7
Watches, Clocks	14.7	17.5	19.8	25.0	20.4	22.4	19.4
Textiles & Leather Machinery	70.0	61.0	60.0	64.7	NA	NA	NA
Polymer related products	69.2	67.6	79.4	88.5	89.2	87.2	91.0
DOMESTIC EXPORTS							
Textiles	25.0	32.6	33.4	33.6	36.2	39.4	42.1
Telecom Equipment	42.9	40.0	46.8	51.1	NA	NA	NA
Watches, Clocks	8.0	8.7	10.0	11.0	12.8	14.5	18.1

N.B. Changes in product classification after 1989 caused a break in the series.

Additional information on the direction of investment flows from Hong Kong to China can be provided from the activities of the two stock exchanges now operating in Shenzhen and Shanghai. Most of the companies which have so far issued "B" shares, that is shares which can be held by foreigners, are practically all either Hong Kong joint ventures or have Hong Kong companies as their major shareholders. Table 2 supplies the currently available information.

TABLE 2

Chinese companies whose shares are available to foreigners ("B" shares)

Company	Activity	Hong Kong connection
China Southern Glass	Glass	Hong Kong joint venture
China Bicycles	Bicycles	Hong Kong shareholdings
Konka	TV, audio etc products	Hong Kong joint venture
Shenzhen Properties	Property, Construction	Some joint ventures
Huafa Electronics	Colour TV sets	Hong Kong joint venture
Petrochemicals Corp.	PVC, chemicals	Hong Kong joint venture
Victor Onwards	Textile dyeing etc.	Has Hong Kong subsidiary
Zhong Chu	Conglomerate	N/A
Shanghai Vacuum (*)	TV tubes	Hong Kong shareholdings
No. 2 Textile Machinery (*)	Textile machinery	N/A

(*) Listed in Shanghai. The rest of the companies are all listed in Shenzhen. Situation in July 1992

It is obvious that the majority of the listed companies, particularly those in the Shenzhen stock exchange, have strong links with Hong Kong both in terms of direct shareholdings and in terms of joint venture undertakings. Furthermore Hong Kong investment in these companies is greater than the direct holdings of their joint venture partners. For example of Konka's 138.9 million issued shares, 48.4 millon are held by its Hong Kong partner Kong Wah Electronics, but another 10.0 million is held by other foreign investors which will include Hong Kong residents. In view of the dispersion in the ownership of shares it is difficult to establish the exact amount of direct equity participation by Hong Kong entities.

Further evidence of Hong Kong's investment links with China is provided by the activities of major listed companies in the stock exchange of Hong Kong. Table 2 summarises some of the evidence.

The companies and the activities listed in the Table pertain not to general trading and other commercial links, but to actual investment or equity participation in Chinese companies. So, for example, HK Telecom, the biggest quoted company in Hong Kong, does not appear in the list because at present it benefits only from the telephone traffic generated by China rather than because of actual projects or undertakings there.

TABLE 3

Listed Hong Kong Companies with strong China Links

SECTOR	CHINA ACTIVITY
Property-Construction	
Hopewell	Road and power station construction
Kumagai Gumi (HK)	Office and residential construction
New World Development	Road construction and property development
Tian An	Property development
Industrial	
China Paints	Paints and transport projects
Kong Wah	TV sets manufacturing
Luks International	TV sets manufacturing
Truly International	Electronic components manufacturing
Yue Yuen	Sports shoes
Hai Hong	Paints. Part of a PRC owned conglomerate
Diverse-Conglomerates	
China Light	Joint ventures in power stations
Lam Soon Food	Oil and flour production and processing
CP Pokpkand	Animal feeds, Poultry, Bicycles

By necessity the list in Table 3 is far from exhaustive. There are numerous other listed and unlisted Hong Kong companies which invest directly in production and other facilities in China. In terms of overall size, however, the commitments of two Hong Kong companies must be mentioned.

China Light has the exclusive right to supply electricity to Kowloon and the New Territories of Hong Kong. The company has a number of joint venture schemes in Guangdong. Firstly, it has a barter agreement with the generating authority of Guangdong, supplying electricity in return for coal. China Light is now providing nearly 8% of the province's power needs. Secondly, the company has a 25% stake at the Daya Bay nuclear power station and 50% interest in another pumped storage power station in the province. The output of these stations will be sold not only to the Guangdong province but also to China Light itself.

Hopewell Holdings is a well known property development and investment company in Hong Kong. In the early 1980s the company became progressively involved with infrastructure projects. The China project that has received most attention is the construction of a "superhighway" which will link Hong Kong with Guangzhou (Canton). The project also includes related construction projects including shopping complexes at selected junctions. Hopewell has also constructed, and is currently constructing, power stations in China.

Developing Trends, Summary and Forecast

The absence of detailed statistics on the exact size and distribution of the investment flows between the two economies, does not prohibit the drawing of some general conclusions.

Firstly, China's investment in Hong Kong is broadly based and spread over a number of key sectors. This may well serve a political as well as portfolio diversification end, signalling to Hong Kong and to the rest of the world that China is commiting its own resources to Hong Kong's future.

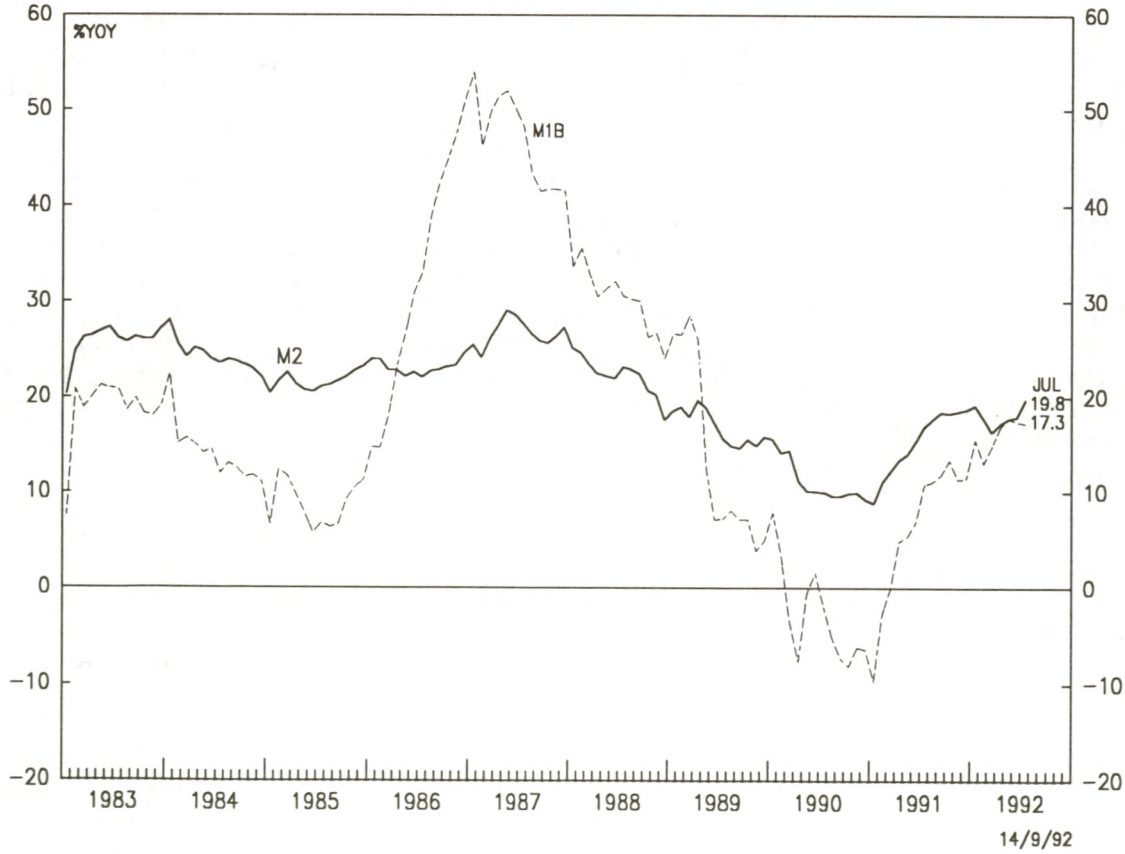
Secondly, Hong Kong's investment in China has been connected so far to the export and re-export trade, except that there is a growing trend towards investment in either major infrastructural projects or in property and domestic consumer industries. Infrastructural projects and property investment are more likely to be affected by cyclical variations in China's own economy, whereas investment in the export sector relies heavily on the performance of the US economy. The absence of detailed data does not permit the quantification of these two different types of investment, that is infrastructure-domestic versus exports oriented, but the former is likely to be more important than the latter.

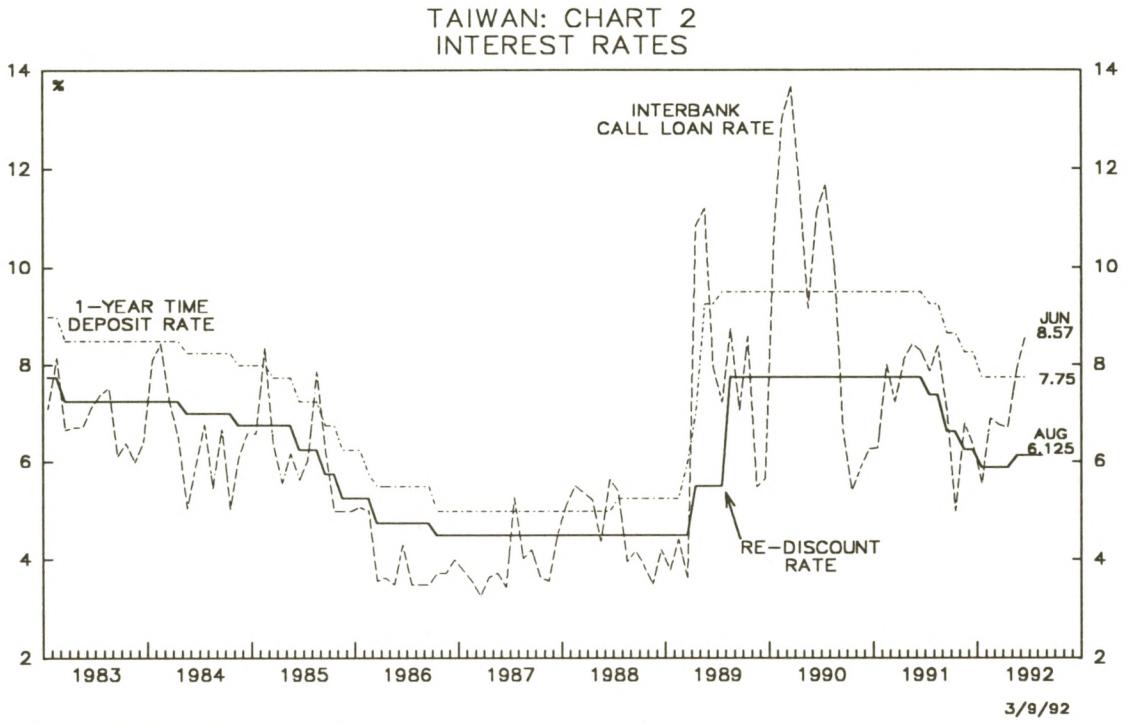
The importance of Hong Kong as the single most important foreign investor in China is partially reciprocated by China's own consistent third position in the foreign investment stakes in Hong Kong's manufacturing sector. The sheer size of China's infrastructural and developmental needs make it most likely that the involvement of Hong Kong companies in direct investment projects in China will be in that direction. This trend is likely to be partially counterbalanced by the continuous stream of Chinese companies seeking listings on China's two stock exchanges and drawing substantial equity contributions from their Hong Kong partners or investors. The eventual listing of some of these shares on the Hong Kong stock exchange will strengthen the portfolio investment flows. Indeed as China's financial system is liberalised and developed the use of the equity market may well take precedence over direct "greenfield" investment and thus give rise to genuine Hong Kong-China conglomerates.

TAIWAN
FACTORS PREVENTING THE NEXT ASSET PRICE EXPLOSION

From a macroeconomic perspective, conditions have been in place since early 1991 to support an appreciation in Taiwanese asset prices. For example, broad M2 money growth troughed at 8.9% yoy in January 1991, rebounded sharply, and has remained in a 16-20% range since June 1991 (Chart 1). Real GDP growth accelerated from 5.0% in 1990 to 7.3% in 1991 and should expand around 6.5-7.0% during 1992. The Central Bank of China (CBC) has cut interest rates (as measured by its re-discount rate) 5 times since July 1991 from 7.75% to 5.875% (Chart 2), although it subsequently raised (perhaps temporarily -- see AMM Vol. 16 No. 3) this rate by 0.25% in May 1992. Finally, but by no means exhaustively, the external accounts are extremely healthy and foreign exchange reserves stood at a world record US$86.6 billion by June of this year. Nevertheless, asset prices have remained extremely subdued over this period. The stockmarket is around the same level as at the end of 1990 while property prices have also remained flat on average over the same period. This article therefore offers a summary and a critique of the many explanations offered for these asset price disappointments, and attempts to gauge when these disappointments will come to an end.

TAIWAN: CHART 1
MONETARY GROWTH



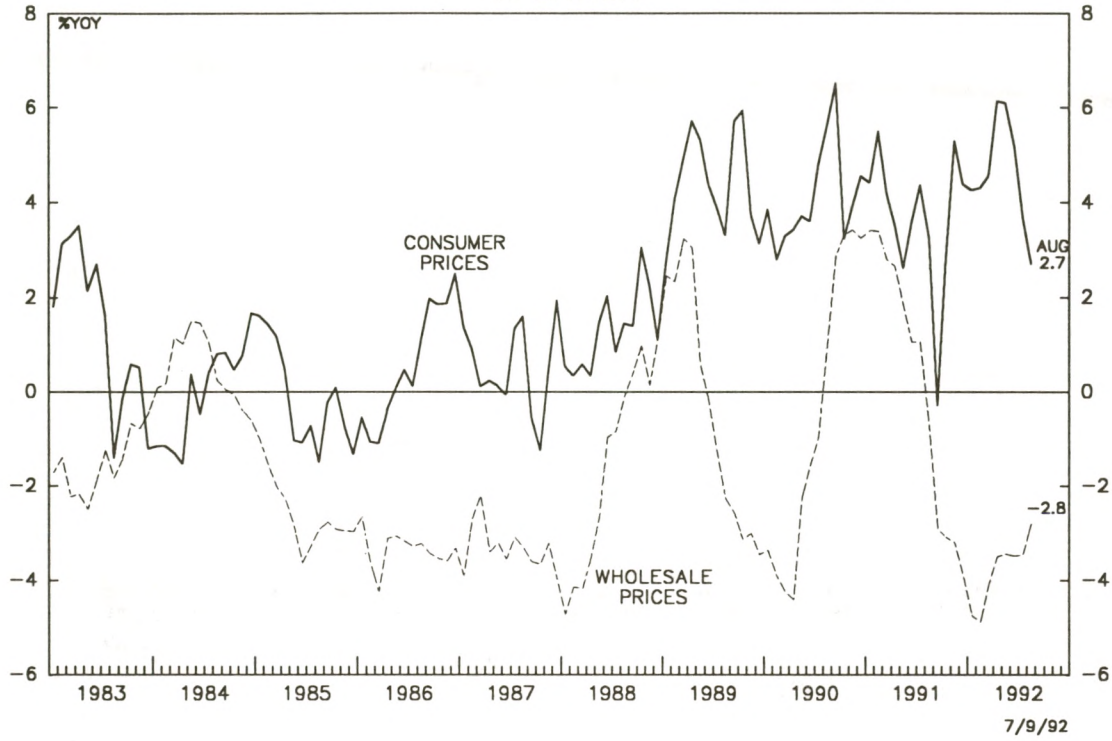


1. High Real Interest Rates

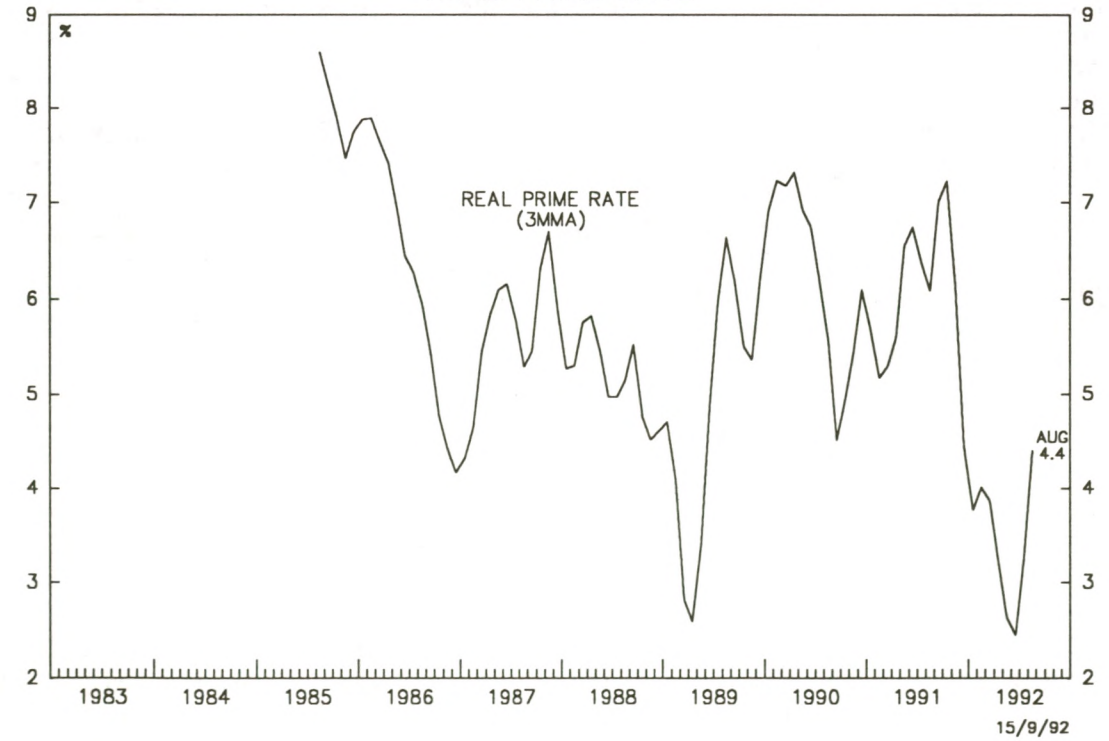
The CBC tends to present an appearance of crisis management in the way it switches between short term policy objectives such as preventing currency appreciation, discouraging bank lending etc. As such, it often gives the impression that it is simultaneously trying to control the price and the quantity of money, as well as the exchange rate. However, the CBC claims that its primary long term objective is the control of CPI inflation, and to this end cuts in interest rates have been made reluctantly and often only as an attempt to offset currency appreciation. As explained in AMM Vol. 16 No. 1, inflation has been volatile during 1992 due to 1991 base effects and erratic food prices, and the May 1992 interest rate rise appears to have been a kneejerk reaction to a temporary spike in fresh produce prices (Chart 3). Underlying inflationary pressures appear to be weak. Wholesale prices were still contracting 2.8% yoy in August -- the CPI/WPI gap is officially attributed to poor distribution channels which will require further microeconomic reform -- while wage rises are not significantly above productivity growth. With the headline CPI moderating to 2.7% yoy in August and expected to remain within a 2.5-3.5% range, further interest rate cuts are likely -- especially if the NT$ continues to come under appreciation pressure.

Have high real interest rates held the economy back? First, if one takes a measure of real interest rates as bank prime lending rates minus the CPI, then rates are not historically high (Chart 4). Second, investment growth has been reasonably robust. Total capital formation increased 10.8% during 1991 although the private sector component rose only 3.3% (Chart 5). Nevertheless, domestic private investment growth has been weak for a number of years as a consequence of Taiwanese companies shifting their production facilities overseas. The conclusion is therefore that "high" interest rates have not significantly dampened economic activity. On the other hand, nominal interest rates remain high relative to the lows of 1986-88, and this may well have affected adversely stockmarket sentiment.

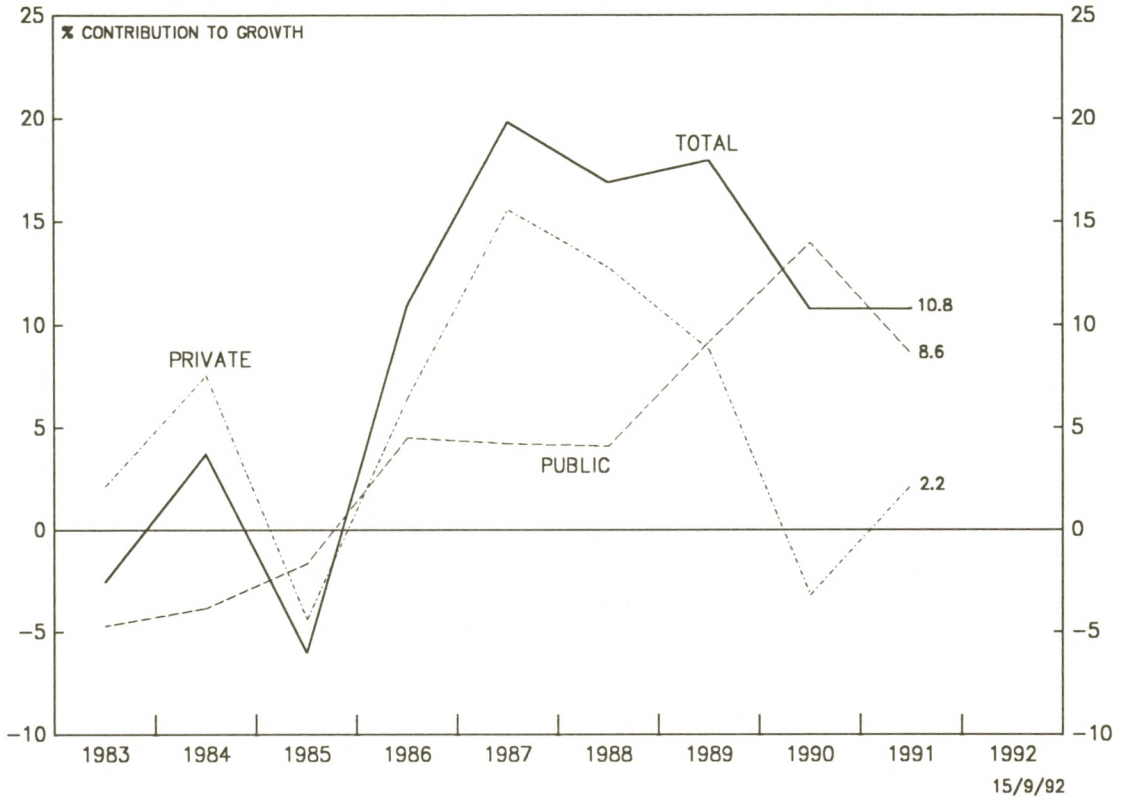
TAIWAN: CHART 3
INFLATION



TAIWAN: CHART 4
REAL PRIME RATE



TAIWAN: CHART 5
CONTRIBUTION TO TOTAL CAPITAL FORMATION GROWTH



2. The 6-Year Development Plan

The NT$8.2 trillion to be spent over the period 1991-96 has various implications for asset prices via its funding and its implementation. On the funding side, government bond issues have been cited as a reason for poor stockmarket performance via their counter claim on liquidity. The government planned to raise a total of NT$950 billion over the life of the plan, including NT$287.5 billion during fiscal 1991-92 and NT$235 billion during fiscal 1992-93. However, five auctions during 1991-92 only raised NT$180 billion and two further auctions have subsequently raised an additional NT$70 billion. The truth is that the government has not needed the money although the issues (after the adoption of a bidding system in fiscal 1991-92) have been heavily oversubscribed. The government's tax yield has been much higher than expected -- a 21% rise during 1991 compared to the 8% budgeted for -- and many of the larger projects are running behind schedule and hence have not taken up all their allocated funds. For example, the central government publishes an analysis of projects under its direct control (the others are being supervised by local authorities and other government agencies, or have been put out to private sector tender) which total NT$3.2 trillion. During fiscal 1991-92, NT$683 billion should have been spent, but only NT$509 billion (or 75%) was actually realised. Projects involving the construction of reservoirs, motorways and railways have stalled due to labour shortages -- unemployment is less than 1.5% and Taiwan is extremely reluctant to import foreign labour -- and difficulties in purchasing land.

Bond issues may well have played a part in diverting liquidity away from the stockmarket in the short run, but the issue size has not been sufficient to be called a long term liquidity drain. Conversely, the government's land purchase plans could reasonably have been expected to shore up certain sectors of the real estate market. However, it has been unwilling to offer sufficiently high prices for the land it requires and thus transactions have all but dried up. Various schemes involving forms of compulsory purchase have been proposed, but ultimately the government will probably have to accept that it has to pay higher prices.

3. Privatisations and New Issues

Under the Plan, a further NT$150 billion is to be raised from the privatisation of state-owned enterprises via the sale of government stock holdings. The government has succeeded in subduing stockmarket performance by dumping large lines of stock every time the market has tried to stage a rally. NT$55 billion has been raised in this manner since the beginning of 1991.

In addition, at the end of 1991, the government granted licences to 15 new commercial banks which each had to raise NT$10 billion in capital. This process is now over and thus the drain on stockmarket liquidity has been removed. The banks are now adding to liquidity as they seek to expand their loan books rapidly. This has been a significant factor behind the surge in bank lending to the private sector -- currently growing at almost 30% yoy (Chart 6).

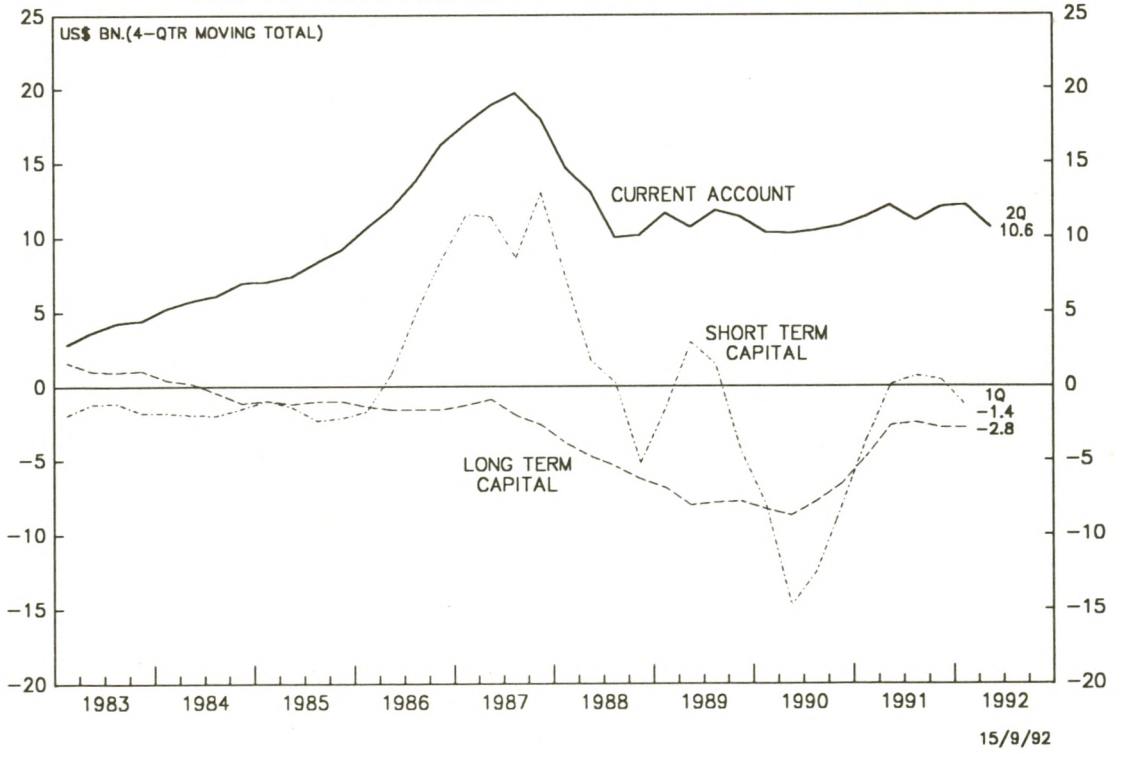
TAIWAN: CHART 6
M2 AND BANK LENDING TO THE PRIVATE SECTOR

4. Capital Flight to China

As relations between Taiwan and the People's Republic of China have thawed, so the Taiwanese authorities' tolerance of investment on the Mainland has increased. Although direct investment in China is still illegal, indirect investments via third countries are allowed and officially these have totalled US$3.4 billion since 1988 (actual investment is probably significantly higher). Trade with China, mainly via Hong Kong, has also surged from around US$1 billion in the mid 1980s to US$5.8 billion in 1991 -- around 4% of total trade. Finally, anecdotal evidence suggests that Taiwanese investors have been heavy buyers of shares on China's fledgling stock exchanges.

It is now being argued increasingly that capital outflows to China are resulting in a dearth of speculative capital in Taiwan and thus depressing asset prices. While there is little doubt that Taiwanese investments in China -- both long term and portfolio -- are underreported, their effect on domestic liquidity is probably overstated. If capital were indeed flooding out of Taiwan then one would expect to see a sharp reduction in foreign exchange reserves. In fact reserves are still accumulating. The current account surplus is steady at around US$10-12 billion per annum (Chart 7), long term capital outflows of US$3 billion per annum are also relatively stable, while the short term capital account may well have moved back to an inflow during 1992, as funds have been attracted to the NT$ by high interest rates relative to the US$. Certainly, money is smuggled out of the country in contravention of individual limits -- currently US$3 million per person per annum -- but it would require an awful lot of suitcases full of NT$ to cause the sort of drain currently being discussed.

TAIWAN: CHART 7
THE CURRENT AND CAPITAL ACCOUNT BALANCES



Nevertheless, Taiwanese investment flows into China do exceed official figures and this money must come from somewhere. The most plausible explanation is that Taiwanese companies with operations abroad are using the profits generated by these overseas subsidiaries as seed money in China. Such diversion of funds has no impact on the balance of payments save a smaller inflow of remittances. It is, however, consistent with the poor earnings figures reported by Taiwanese companies -- the subsidiaries would have to underreport earnings in order to divert funds to China undetected -- which do not seem consistent with macroeconomic data.

5. Earnings Growth is Weak

Taiwan remains an export oriented economy -- exports accounted for 40% of GNP in 1991 -- so it is of little surprise that earnings growth has been unspectacular in the face of slow growth of the world's major economies. Nevertheless, until the last few months, export growth remained quite respectable (Chart 8) and can be expected to pick up again as and when a stronger recovery in the US emerges. The strength of the NT$ against the US$ will not help -- it has appreciated 10% against the Greenback since the middle of 1991 -- but on the other hand, the currency does not appear to be overly expensive given Taiwan's balance of payments position or its relatively low level of underlying inflation.

Trade with South Korea will certainly be affected by that country's decision to switch its diplomatic recognition to China. However, the direct trade between Taiwan and Korea is not significant and favours the latter anyway (Chart 9).

Overall market earnings are expected to contract around 5% during 1992 but this performance is biased downwards by the poor performance of the financial sector (-25%). Banks have been hit by deregulation and the granting of new licences which has heightened competition and eaten into (perhaps permanently) previously earned supernormal profits. Domestically generated corporate profits are also likely to be weak reflecting single digit industrial production growth (Chart 7). However, this in turn reflects the relocation of Taiwanese manufacturing overseas and is a phenomenon mirrored, for example, in Hong Kong's domestic production figures. Excluding these two sectors (banks and domestic industrials), earnings growth appears to be reasonable and could well be understated due to reasons discussed in the previous section.

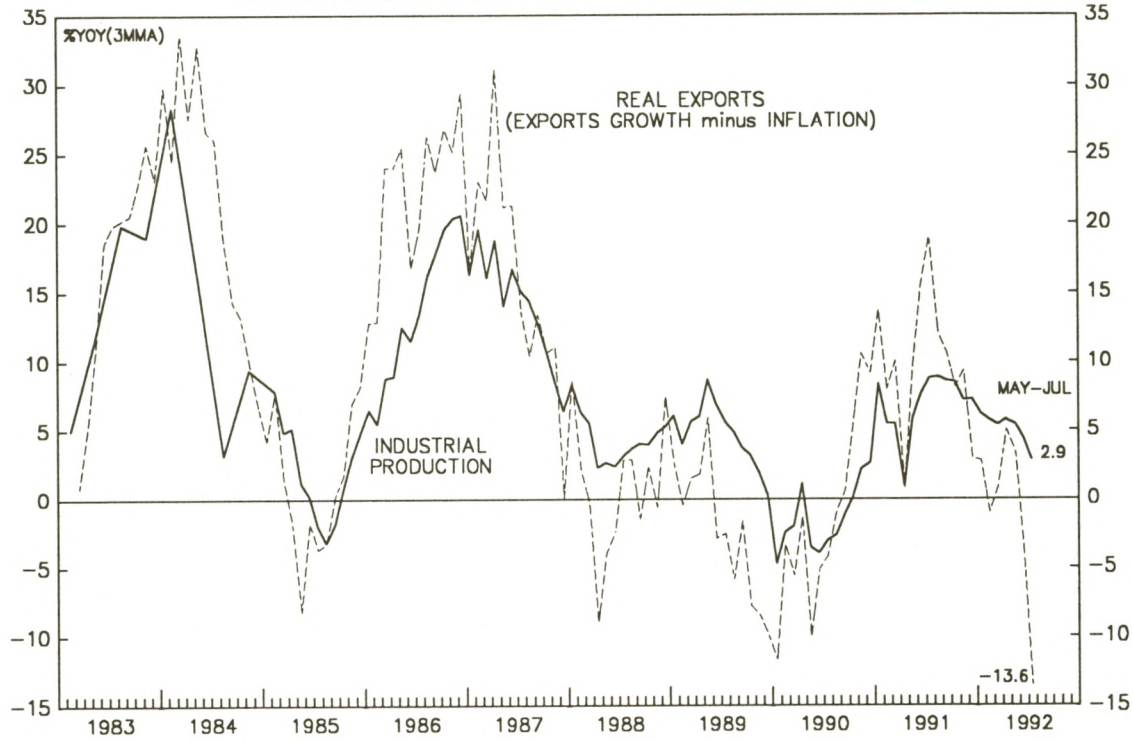
6. Asset Prices are Still too Expensive

Share prices are still 70% below their peak while property prices based on Taipei's residential index, have fallen 20% since 1989 and have remained flat since the end of 1990 (Chart 10). Nevertheless, it can be argued that asset prices remain too high. The stockmarket trades on a PE of 25 times 1992 earnings (financials are nearer 35 times) which makes it the Asian region's most expensive market after Tokyo.

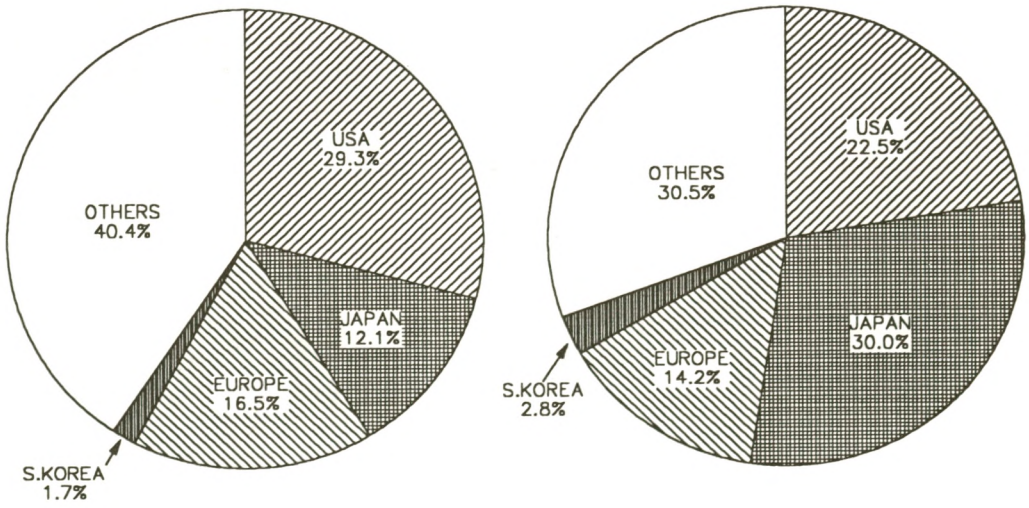
Similarly, property prices are still by no means cheap. The government's index priced the cost of a 500 square foot apartment at US$135,000 at the end of 1991 -- 17 times the average per capita income.

These valuations could well place a ceiling on upward movements but they are also unlikely to result in a further major derating (with the possible exception of financial sector shares). Ample liquidity and certain supply/demand imbalances

TAIWAN: CHART 8
INDUSTRIAL PRODUCTION AND REAL EXPORTS



TAIWAN: CHART 9
COMPONENT SHARES OF EXPORTS AND IMPORTS (1991)

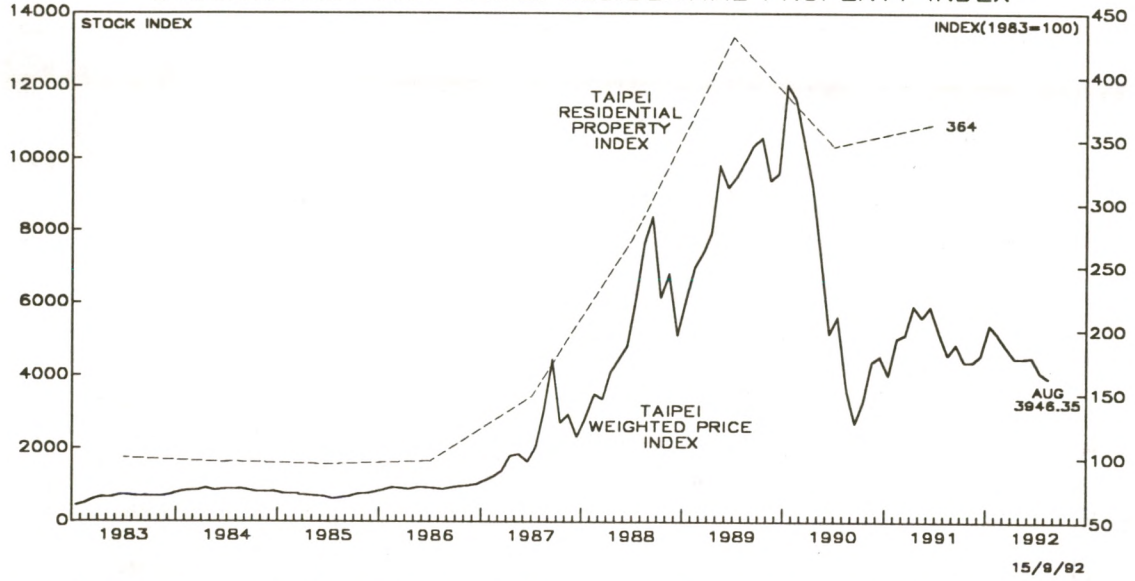


EXPORTS = US$79.3 BN.

IMPORTS = US$65.7 BN.

4/9/92

TAIWAN: CHART 10
STOCKMARKET AND TAIPEI RESIDENTIAL PROPERTY INDEX



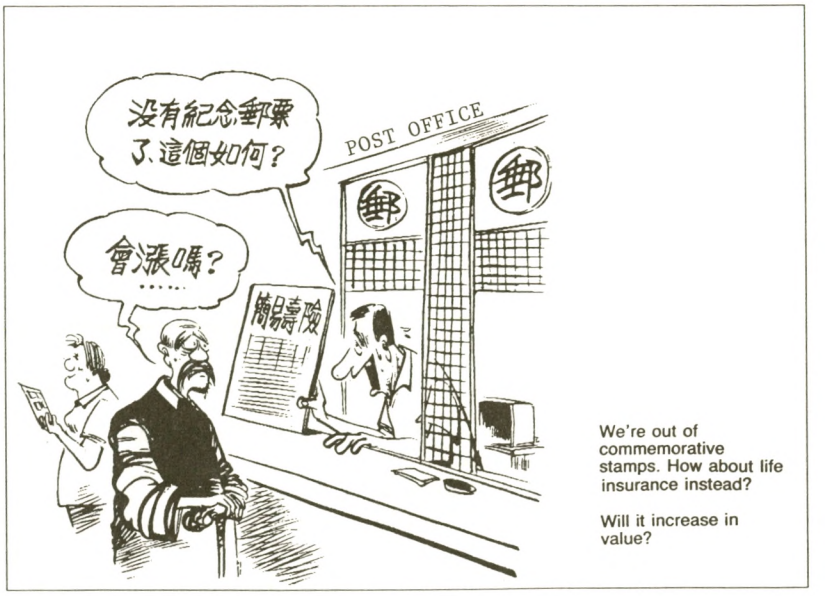
should at least support stock prices. Furthermore, the government's land purchase requirements for the Development Plan should place a floor under property prices -- for example, prices are supposedly rising in the areas earmarked for the new Taipei metro system.

7. Moral Suasion

The Taiwanese authorities have consistently stated that they wish to prevent another asset price explosion and appear to have been remarkably successful in their manipulation of market forces. There are a number of reasons why the government has tried to keep the lid on asset prices. A selection includes: (1) concerns over social equity -- those Taiwanese not on the property ladder in the mid 1980s now feel aggrieved that they cannot afford to buy; (2) as the democratisation of Taiwan accelerates the government has to accommodate electoral considerations into its platform, and attacking high-profile speculators is good politics; and (3) the government itself (or individuals in the government) lost substantial sums in the asset price crash and wishes to punish those it sees as responsible.

CONCLUSIONS: Taiwanese assets have failed to perform in the face of a benign macroeconomic environment for a myriad of different reasons. Some of these constraints have either been removed (new bank listings) or are diminishing (the government has said that it will "proceed slowly" with future privatisations). Others (bond issues, the attractions of Chinese investments) remain. However, given that inflation is moderating and that the NT$ is still under upward pressure, interest rates should continue to fall and money and credit growth should remain buoyant. The key factor remains the government's attitude towards land prices and the stock market. Although prices may remain weak in certain overbuilt sectors, the demands of the development plan and a fundamental lack of space should underpin the real estate market. As for the stockmarket, the government appears to be softening its stance prior to December's elections for the Legislative Yuan. Some sort of appreciation can therefore be expected towards the end of the year, but it remains to be seen what the government's attitude will be thereafter.

民生報 • 禿鷹 Cartoon by "The Vulture" (from the *Minsheng Daily News*).



Source: Sinorama, July 1992

TAIWANESE STAMPEDE

The Taiwanese have a reputation for being among the world's greatest speculators -- in the late 1980s, many people quit their jobs to play the stockmarket full time -- but they have been loathe to commit themselves to equities or property in recent times. Nevertheless, you cannot keep a good speculator down and their attention has merely been switched to other forms of assets.

One example is the explosion in the market for commemorative postage stamps. Figures published by the Directorate-General of Posts in the Ministry of Transportation and Communication show that its income from collectable stamp sales had increased to NT$2 billion for the five months to May 1992 from NT$200 million per annum before 1990. Speculators have been buying stamps by the package -- each package includes 200 sheets -- with the result that the entire run sells out within the day. This is despite an increase in the number of sets being issued from 1.5-2 million to 9-10 million. Prices have also surged in line with demand -- for example, a set of "children's toys" stamps went from NT$20 to NT$250 within one month of issue.

The market is taking on other characteristics of the stock market. Stamp shops are opening in large numbers, stamp investment pages have appeared in some newspapers and a "big board" of current stamp prices has been introduced. Old stock clubs which used to ramp share prices are reforming themselves into stamp clubs, and "major players" are emerging such as "National Taiwan Normal University Hsu" who is believed to have invested more than NT$1 million in stamps. The bubble is also being expanded by investors on the Mainland which has 7-8 million registered stamp collectors. The rationale is that when reunification occurs, Taiwanese stamps will become collectors items of great value.

Ominously for investors, the market has started to show signs of topping out and like most bubbles, the deflation is likely to be abrupt. At a huge stamp auction held in June, some of the recent favourites such as the "children's toys" failed to make their minimum price. Taiwanese may therefore soon be looking for a new speculative vehicle. Who knows, they may even want to try equities!

TURKEY
A DANGER OF HYPERINFLATION

Turkey has experienced persistently high rates of money supply growth. There was a sharp downturn in money growth in the second half of 1990 and early 1991 caused by the heavy capital outflows triggered by the Gulf Crisis and War. However, the longer term trend has been one of successively higher cyclical troughs and peaks in money growth since 1983, as shown in Chart 1.

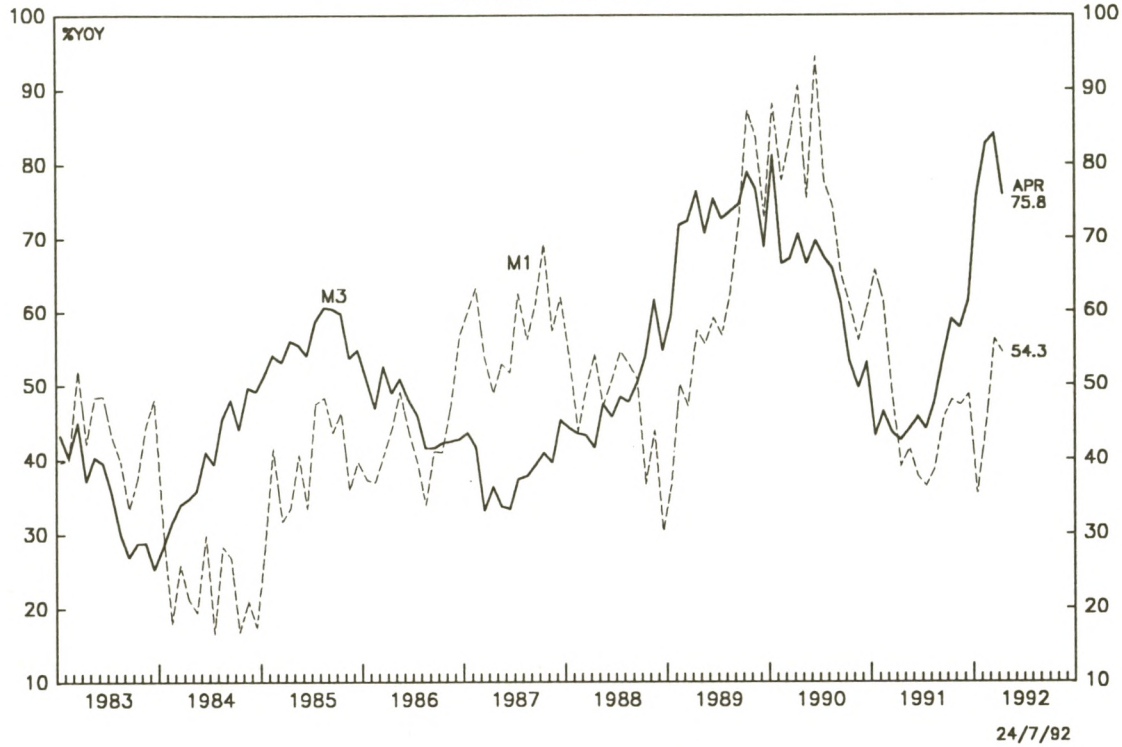
At the beginning of the 1980s, one of the main objectives of money and exchange rate policy was to depreciate the Turkish Lira by more than inflation in order to promote exports. Therefore, the real exchange rate for the Lira was falling over this period. (See Chart 2.) Such a policy tends to generate further inflation and is not viable in a regime of liberalised capital movements. Turkish exchange controls were removed over 1989-90. Two important decrees, of August 1989 and March 1990, completely transformed Turkey from a comparatively closed economy to a completely open one. Over 1989 and 1990 the real exchange rate rose as the rate of currency depreciation was held below the inflation rate. A strong balance of payments position put upward pressure on the real exchange rate and the government preferred to limit the rate of depreciation of the Lira in order to damp inflationary pressures. The real exchange rate fell during the Gulf War and over the pre-general election period in 1991. Current government policy is to keep the real exchange rate stable, depreciating the Lira at a rate roughly equal to the domestic inflation rate.

Against this background, the source of persistent very high money growth has been domestic lending by the central bank, particularly to the government, as the creation of money has been used as a primary method of financing the government's deficit. Over 1984 and 1985 the deficit was ultimately partly financed via a large drop in foreign reserves. Between 1986 and 1988 the more disturbing trend was of sharply rising monetary base growth. Over 1989-90 the domestic component of money base growth was reined in. Together with the policy of appreciating the real exchange rate and the Gulf Crisis, this brought about the monetary contraction of 1990. The most recent period has, worryingly, seen a reversal of this process with a renewed rise in the domestic component of monetary base expansion. (See chart 3.)

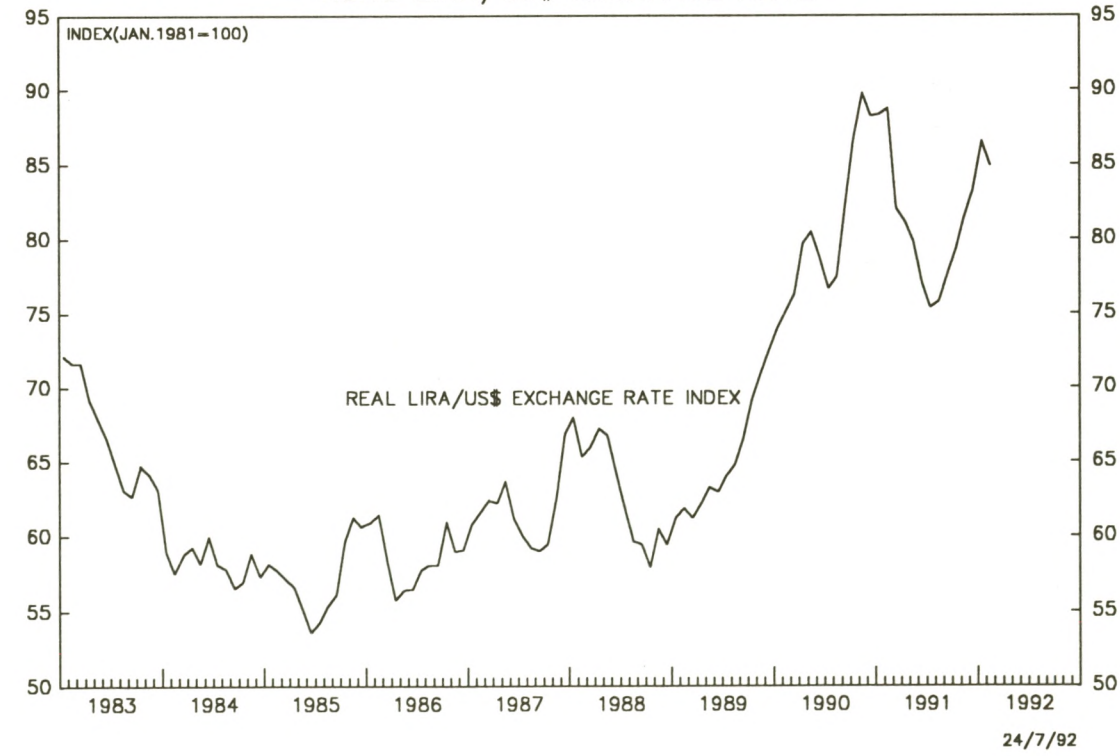
Even though the rate of increase of the domestic component of the base is now lower than the peak rates of increases over 1985-88, the risk of hyperinflation is now far greater. The dramatic financial deregulations of 1989-90 have completely changed the way individuals and companies react to the threat of inflation and therefore altered the behaviour of the key economic variables. The combination of the political incentive to create inflation and the effect on the velocity of money as people act to avoid the "inflation tax" make deficit monetisation a particularly dangerous policy in a deregulated economy.

Chart 4 shows the relationship between monetary base growth and inflation over the past ten years. As the chart indicates, inflation has also had an upward bias. The recent inflation peak was in March, at 78.7% year-on-year. Although the Economics Minister, Mrs. Tansu Ciller, has said that the government is determined to reduce inflation to single digits by 1994, and has a target in the low 30s by March 1993, in general there is a significant degree of complacency with regard to inflation. Because inflation has always been high but never become entirely out of control, the authorities do not tend to see inflation as a serious problem. There is, possibly, a lack of

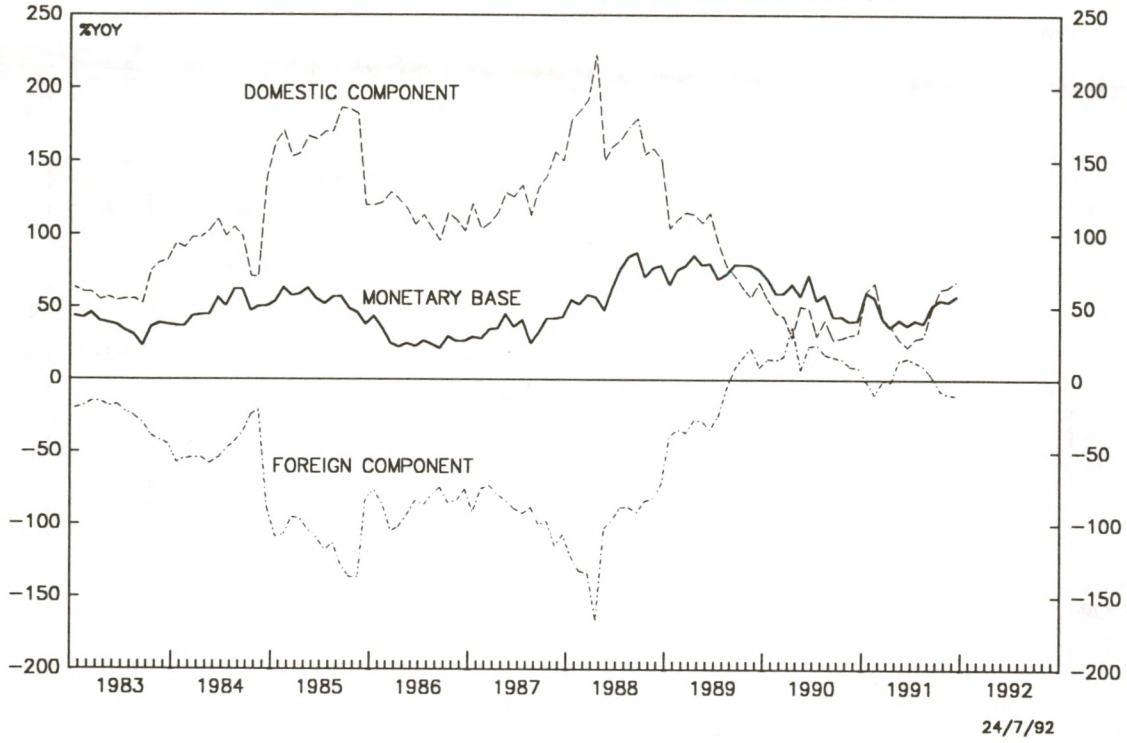
TURKEY: CHART 1
MONEY SUPPLY



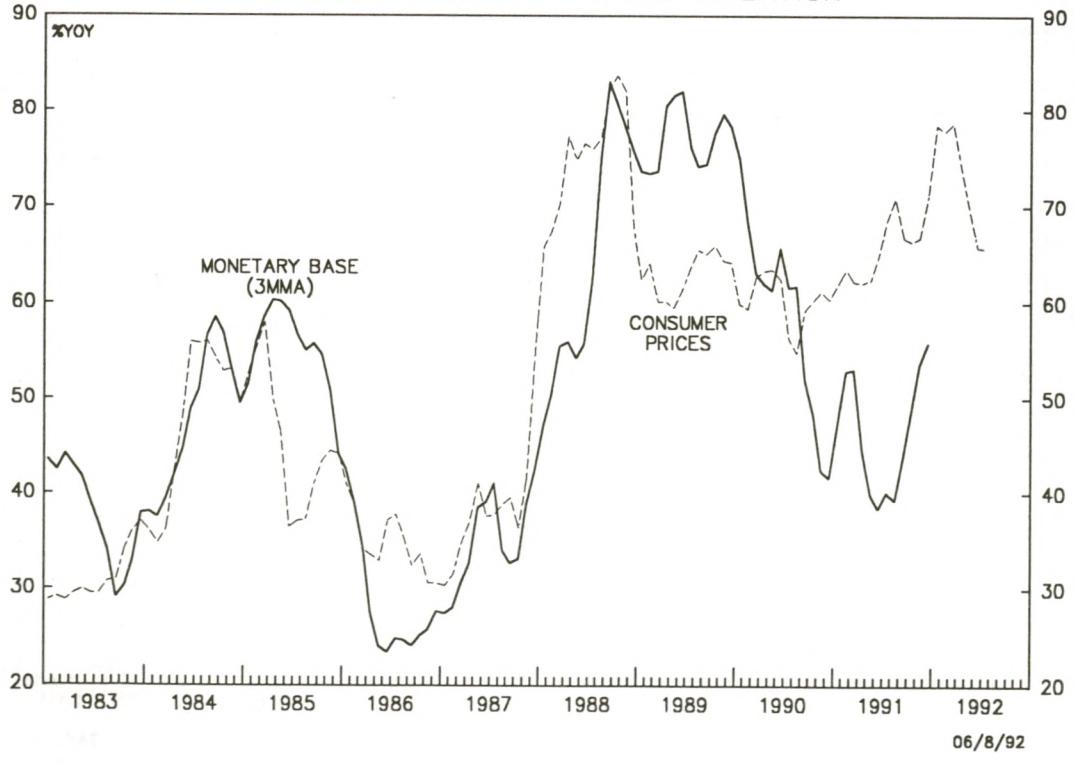
TURKEY: CHART 2
REAL LIRA/US$ EXCHANGE RATE



TURKEY: CHART 3
COMPONENTS OF MONETARY BASE EXPANSION



TURKEY: CHART 4
MONETARY BASE GROWTH AND INFLATION



understanding of the potential for hyperinflation in the newly deregulated economy. In addition, because an inflationary mentality has been built into the economy, there is little popular support for any drastic measures to curb inflation. Any dramatic fall in inflation over a short time period would bring about a large transfer of wealth from borrowers to lenders and threaten the stability of the domestic banking system, which has thrived in an environment of gradually increasing inflation.

Chart 4 highlights the problem which is that, since foreign exchange controls were removed, inflation has begun to run faster than monetary base growth. The result, as Chart 5 shows, is that the real monetary base has begun to contract. To some extent this is perhaps caused by the time lag between money and inflation. Indeed, since January this year, the monthly inflation figures have been improving, perhaps being a delayed reaction to the monetary contraction of 1990 and the consequent economic slowdown in 1991. However, the more substantive reason is likely to be the beginning of a trend decline in the inflation tax base, as deregulation has made the avoidance of the inflation tax legal and easily available to everyone.

There are two components to the monetary base -- and therefore the inflation tax base -- banks' reserve deposits held at the Central Bank, and the note issue. Reserve requirements in Turkey are high -- an average of about 11% of Lira eligible liabilities -- but from the banks' point of view a significant part of the cost of maintaining reserve deposits is offset by the opportunity of subsidised risk-free lending to the government. Banks are required to maintain the equivalent of 32% of eligible liabilities in holdings of government bills and bonds. But they willingly hold at least this quantity of government paper because of a substantial tax advantage. Banks are allowed to deduct income from government paper from net income assessable for corporation tax purposes and pay only the withholding tax on the income. Furthermore, as withholding tax is paid in April of the year following purchase, over time the real burden is significantly reduced by inflation. Additionally, there are further opportunities for avoiding this tax. As a result, banks pay little or no income tax. The net result, therefore, is that banks are not subject to the inflation tax as such. Instead, their opportunity for subsidised lending to the government "crowds out" private sector borrowers and acts to raise real interest rates.

The pure inflation tax is therefore levied through the constant fall in the real, or foreign currency value, of the Turkish Lira note issue outstanding. The problem here is that, to its credit, the government is committed to free capital movements, and the gradual dollarisation of the economy is giving people the opportunity to economise on their holdings of Lira. As the governor of the Central Bank recently remarked "whenever the CB eases monetary policy banknotes issued return to the CB ... in a very short time. They are included either in the CB's liabilities or they cause a decline in net foreign assets through the CB's sale of foreign exchange. We have experienced this in various cases. Whenever we effect agricultural payments, the sale of foreign currency banknotes increases too. Whenever we disburse to the Soil Products Office, we see that the demand for foreign currency is extremely high the day after".

Turkey is still a comparatively poor country and at a stage of development at which the economy should be becoming increasingly monetised. However, as Chart 6 shows, Marshallian k (the ratio of money supply to GNP) is not only markedly lower than for the developed economies (for both narrow and broad money) but it is declining. At least in Lira terms, the economy is being gradually de-monetised, many transactions now being conducted in dollars. There are two aspects to this; first, the

avoidance of the inflation tax: second, the avoidance of the risk associated with lending and borrowing in lira.

Approximately 50% of bank deposits are now held in dollars. Foreign currency bank deposits are subject to high and regularly adjusted reserve requirements, which pay lower than Euro-market interest rates to the banks, but still banks are able to offer very competitive (with the Euro-markets) interest rates to dollar depositors. The reason is that there is a ready supply of willing dollar borrowers who do not have access to overseas banks or the Euro-markets. The apparent inconsistency of both lenders and borrowers preferring dollars despite the presence of the reserve requirements (effectively a tax), which raises the cost, is due to the huge risk in lending or borrowing Lira. Because of very high, and potentially very variable, inflation, there is enormous uncertainty with regard to the true cost or return of borrowing or lending in Lira.

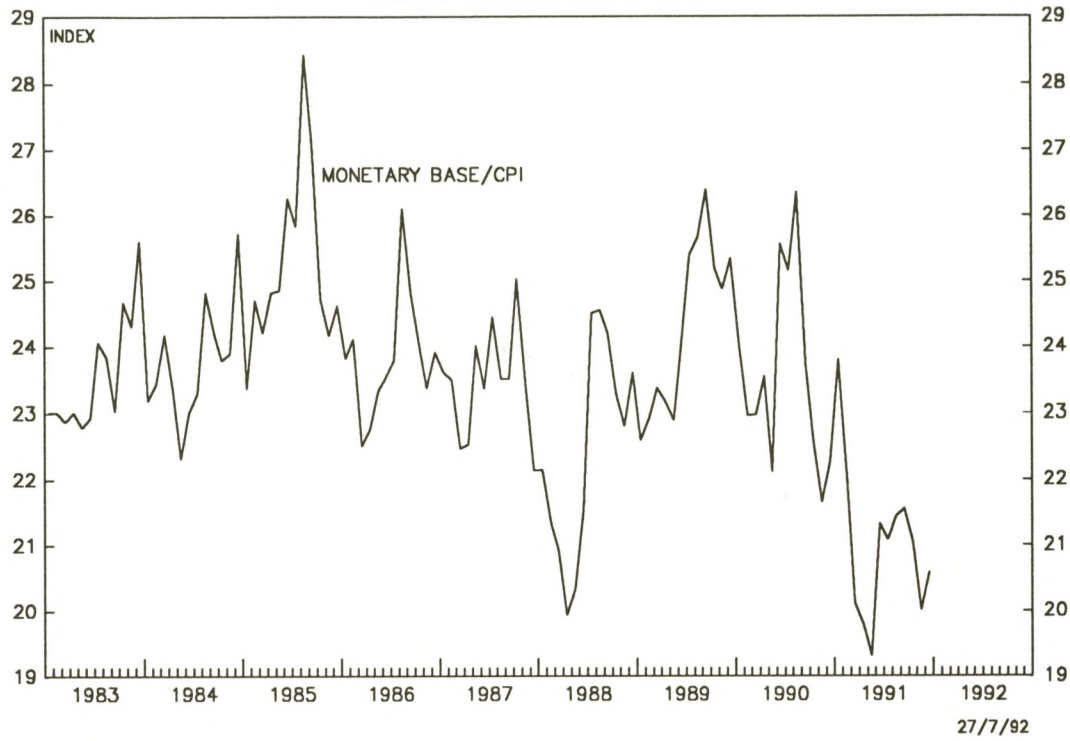
Another aspect of the same problem is the shortening of time horizons in the economy, which tends to be associated with the development of a hyperinflation. In Turkey this shows up in an absence of long term financial commitments/contracts and the virtual absence of liquidity in the debt markets at maturities beyond one year. In the bond and bill market transaction volumes have become increasingly concentrated in the shorter term three month bills. Against the wishes of the central bank, the government has extended the average maturity of its debt from 7 1/2 months in 1991 to 18 months presently, largely achieved through a measure enacted in February which imposed a higher, 15% (as opposed to 10%), withholding tax on short-term securities, and compelled banks (who hold 94% of outstanding government debt) to maintain the average maturity of government debt holdings at greater than 210 days. If this helps to increase liquidity in longer term paper then it is worthwhile. But on the negative side, if the goverment is locked into longer term borrowing, its incentive to reduce inflation may be reduced. In addition, artificially altering the maturity structure of government debt does nothing to address the fundamental problem of the risk perceived in long term financial commitments.

Bank borrowing and lending in dollars does not, in itself, involve capital outflows. Because the transactions are conducted entirely with Turkish residents no capital flows are involved. However, the growth of the associated foreign currency monetary base does involve a capital outflow. Dollar currency notes circulating in Turkey have to be accumulated via a balance of payments surplus and the central bank will require to hold foreign currency assets to back banks' dollar reserve deposits, which also have to be earned through a surplus on the external accounts. As the dollarisation of the economy increases then the seignorage, which includes the inflation tax, from the provision of the monetary base is earned by the US government rather than the Turkish government.

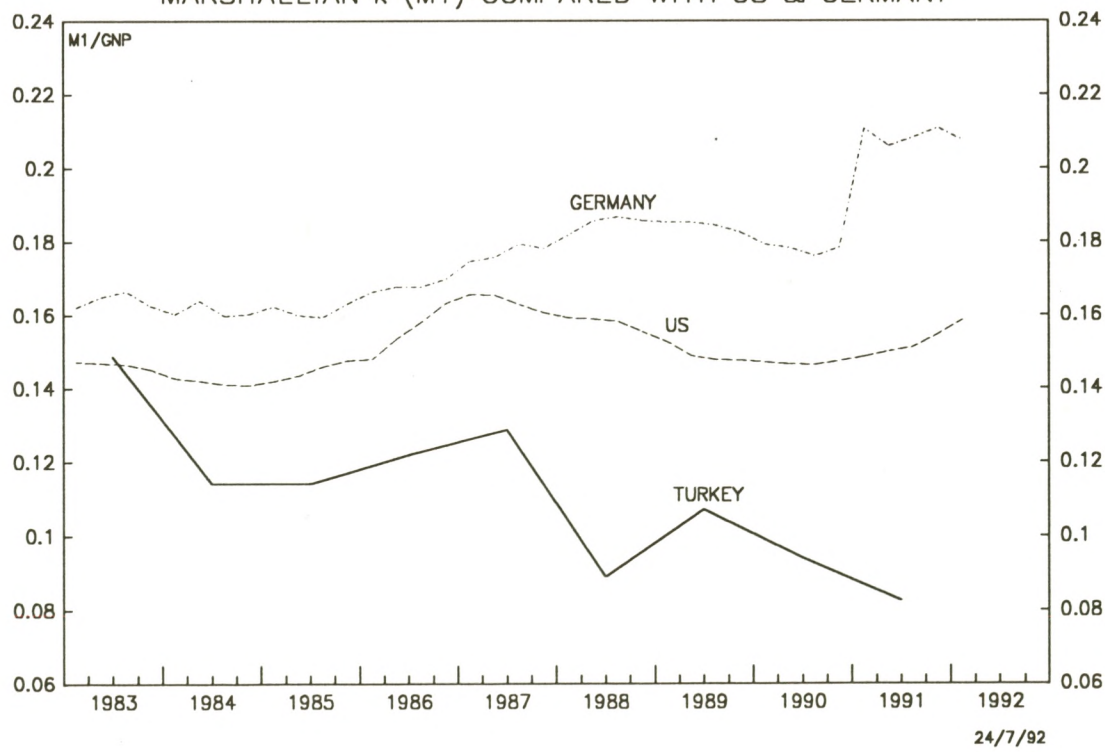
The problem is illustrated in Chart 7, which shows a persistent decline in central bank lending to the government in real terms. As the demand for the Lira monetary base falls, Central Bank lending to the government necessarily falls in real terms. If the government persists in trying to finance the same government deficit in real terms, by money creation, this will involve generating more inflation from the smaller inflation tax base. This then potentially sets in train a vicious circle of spiralling inflation and velocity of circulation of money, which culminates in hyperinflation and, eventually, the total dollarisation of the economy.

This highlights how important it is that the government tackle effectively the

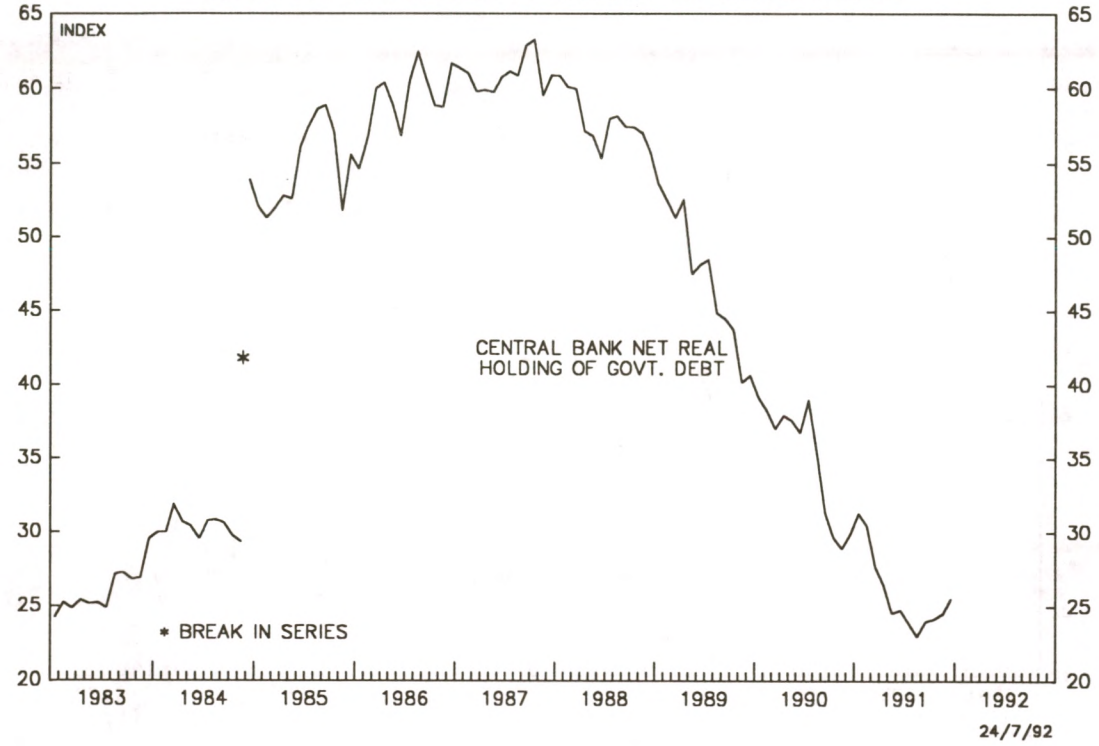
TURKEY: CHART 5
REAL MONETARY BASE



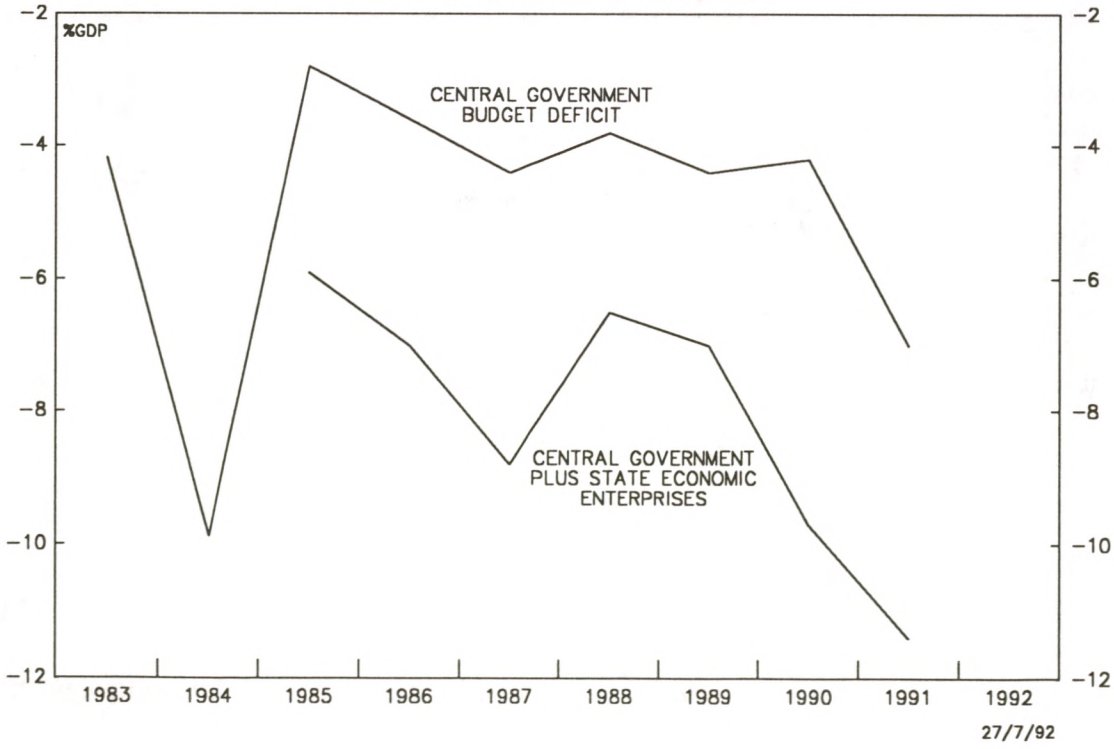
TURKEY: CHART 6
MARSHALLIAN k (M1) COMPARED WITH US & GERMANY



TURKEY: CHART 7
CENTRAL BANK REAL LENDING TO GOVERNMENT



TURKEY: CHART 8
PUBLIC SECTOR FINANCES



problem of the public sector deficit. The Central Bank does not have independent leeway to rein in money creation. Although there is much conflict between the Central Bank and Treasury, the Bank is 51% owned by the Treasury and ultimately it is the government which decides policy. Targets for the monetary aggregates are fixed only after fiscal policy targets have been decided, and in conjunction with them.

Therefore, bringing inflation under control will require bringing the public sector deficit under control. There are three elements to the problem of the public sector deficit which currently is equal to 10-11% of GNP (Chart 8). First is the narrowness of the tax base, a problem exacerbated by the government's frequent tax amnesties, the most recent of which was in April. Although tax reform is on the government's agenda, progress is admitted to have been disappointing, and so far the only concrete measures to have been taken are increases in certain specific tax rates.

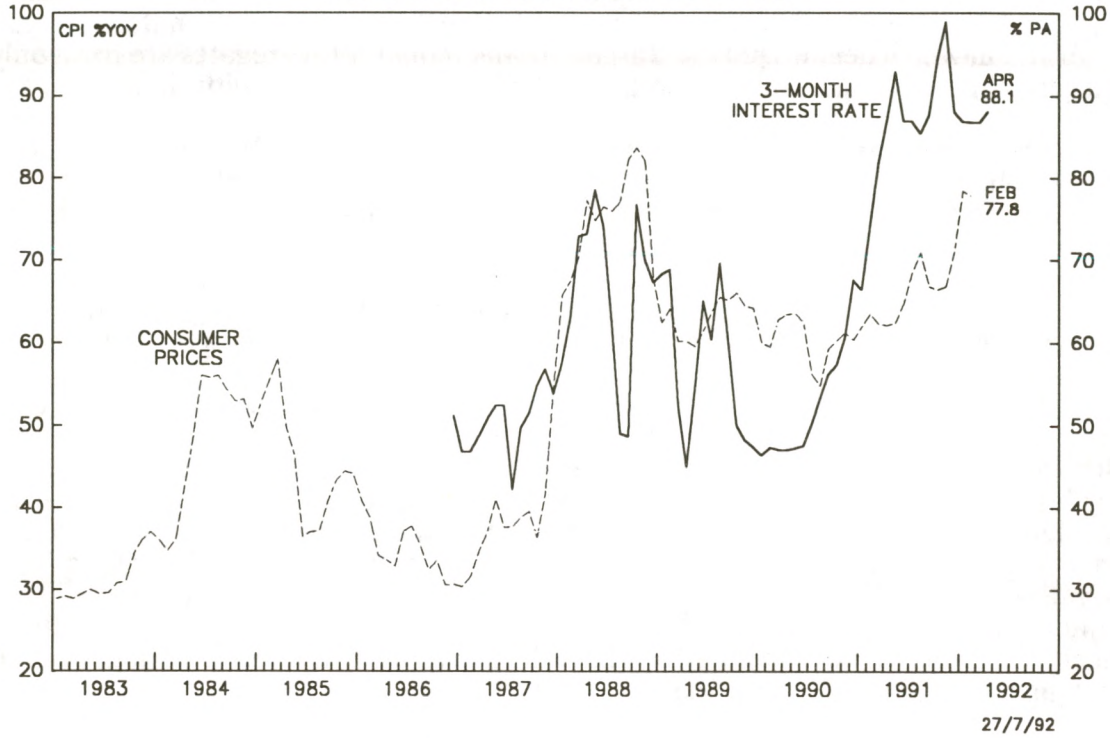
The second problem is the huge nationalised industries sector, the state economic enterprises. This is being tackled through a programme of privatisation which, although it initially encountered difficulties, is now the policy of both major political parties. The privatisation programme should, in the long run, greatly reduce the problem of the state economic enterprises, but the immediate relief to the burden of financing the public sector deficit is comparatively small. Targeted receipts from privatisation for 1992 are TL 5.5 trillion compared to a budget deficit target of TL 32 trillion and a public sector deficit likely to total about TL 70 trillion. Actual realised receipts over the first five months have been TL 1 trillion, compared to a budget deficit running at TL 15.6 trillion for the same period.

The third public finance issue is the 167 extra-budgetary funds, or off-budget agencies (OBAs) which include various agricultural and commodity support price stabilisation funds and support funds for various industries, and agencies involved in redevelopment and protection of the environment and national heritage amongst others. As an initial step towards the government's aim of eventually abolishing the funds, TL 17 trillion of the total TL 74 trillion of revenues of the funds have been consolidated into the central government's budget.

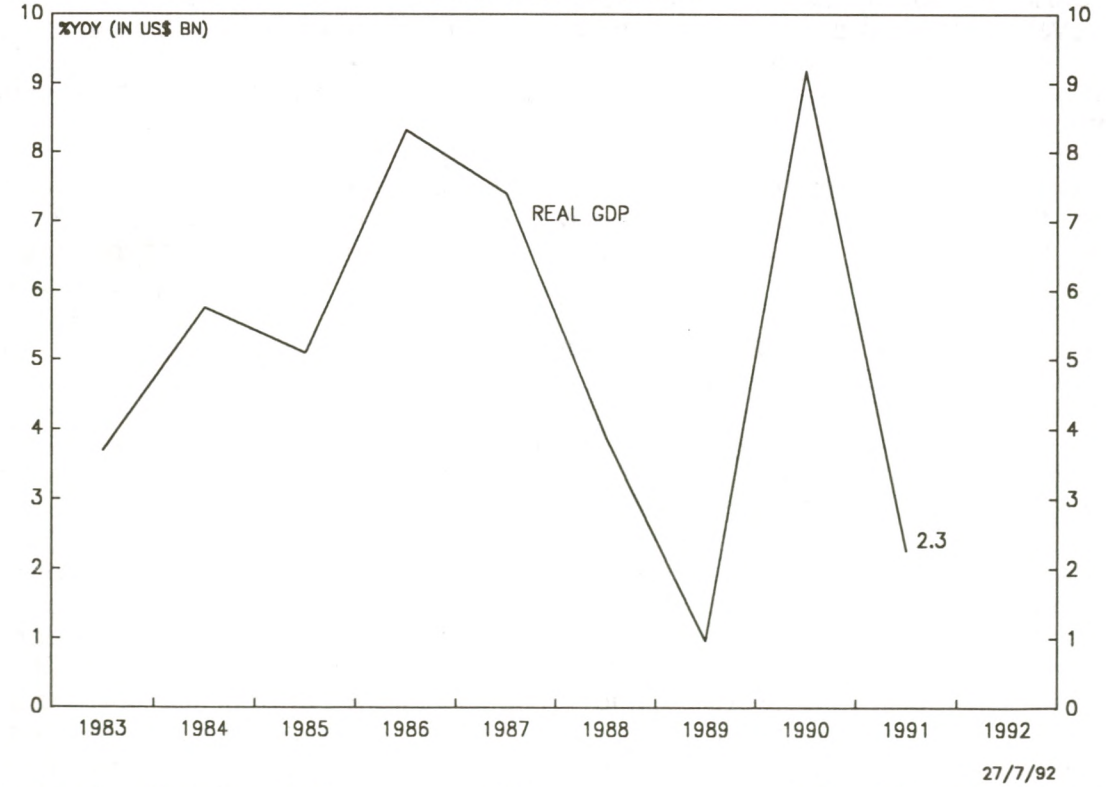
Although the measures taken to tackle the public finance problem have been steps in the right direction, unfortunately they have not been enough to lead to a decisive improvement in the government's finances. Indications are that the budget deficit will continue to deteriorate over the medium term, exceeding the government's targets for this year. The present coalition government appears to lack both the strength and the will to take the more drastic action required, suggesting that the problem will probably become significantly worse before the necessary action is taken.

Nevertheless, interest rates should still fall over the short-term as a result of a change in the policy towards deficit financing pushed through by the new government against the wishes of the Turkish President and the Governor of the Central Bank. The previous government (in power until the October 1991 General Election) had markedly increased the outstanding stock of Treasury Bills in order to finance a sharply expanded budget deficit. This year the government began to come up against the limit, first established in 1989, on short-term borrowing from the Central Bank. For the current year this limit was equal to 15% of government expenditure, or TL 31 trillion. On July 3rd Turkey's Parliament passed the debt consolidation law, writing off intra-public sector debts including short-term Central Bank credits to the Treasury, over-riding a Presidential veto. This effectively allows the government to borrow

TURKEY: CHART 9
INTEREST RATE AND INFLATION



TURKEY: CHART 10
ECONOMIC GROWTH



an extra TL 13.5 trillion from the Central Bank this year, opening the way for an increased rate of monetisation of the deficit.

In the short-term this should allow real interest rates, which had been forced up to extremely high levels (see Chart 9), to fall somewhat. The argument of the economics minister, in pushing through the debt consolidation measure, has been that heavy government short-term debt issuance is more detrimental to the economy than money creation because borrowing at high real interest rates only postpones and compounds the government's financial problem while harming the economy. It is true that borrowing at real interest rates substantially in excess of the economic growth rate, as has been the case in Turkey, is not a viable long-term policy. However, the government's view ignores the relatively rapid feed-through of money creation into inflation and erosion of the real monetary base, described earlier, which makes monetisation of the deficit also ultimately a self-defeating policy.

In addition, rapidly accelerating inflation also harms private investment at least as much as high real interest rates because of the shortening of time horizons associated with hyperinflation. The process of dollarisation of the economy, if it continues, will be associated with low investment and slow economic growth (see Chart 10).

FORECAST: The Turkish government is to be commended for its policy of financial deregulation. Unfortunately, against a background of out of control public finances, this has substantially increased the risk of hyperinflation, a risk now more likely to become a reality following a new measure allowing the government to finance more of its deficit through money creation. In the short-term, the debt consolidation law should allow a reduction of real interest rates. Together with higher money growth this may allow some recovery of the economy over the next year. However, high inflation is encouraging a gradual dollarisation of the economy, a process which will be associated with low investment and economic stagnation over the longer term.

CHINA
A THIRD EPISODE OF GO-STOP

During the 1980s the Chinese economy experienced two episodes of Go-Stop which are shown very clearly in the charts opposite. In each phase of expansion (1984-85 and 1987-88) industrial output soared and was followed by a rise in inflation.

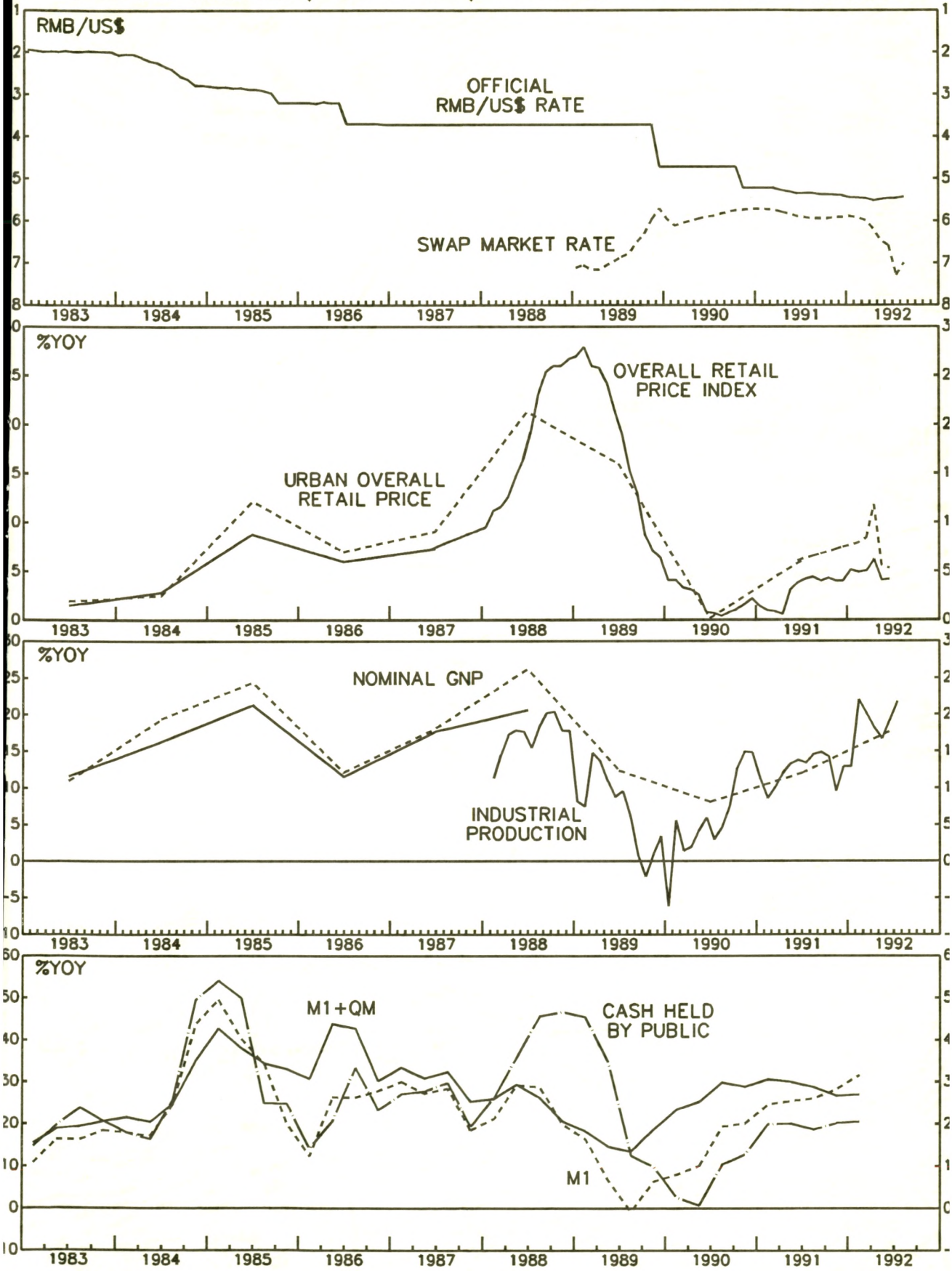
The first episode of inflation was comparatively mild, partly because, after many years of rigid price controls, relatively few prices had been freed up, with the result that the official consumer price indices did not fully reflect the true extent of inflation. In addition, because prices had been artificially held down for many years, inflation expectations were very subdued, which meant that there was no large shift from money to other types of assets, i.e. velocity remained fairly stable. In the second episode of inflation, however, there was both a substantial liberalisation of prices and a much greater movement of velocity because consumers had learnt -- in the intervening period -- about the need to hedge their monetary assets against depreciation, i.e. velocity rose much more sharply.

China is now in the midst of a third episode of expansion. The expansion was initiated by the easing of monetary policy in late 1990 following the austerity drive which had been imposed in the wake of the Tiananmen Square Massacre of June 1989. Since mid-1990 the broadly defined money supply has expanded at close to 30% per annum i.e. for about two years. In addition there has been further extensive liberalisation of the economy, and even in the past few weeks numerous commodity prices have been freed up. Furthermore, during this expansion Chinese mainlanders will have the opportunity to hedge themselves against inflation, either by buying equities on the Shenzhen and Shanghai Stock Exchanges, or, to a limited degree, purchasing land under leasehold arrangements in the Special Economic Zones. In short, velocity could again exhibit a steep rise once inflation is perceived to be a significant threat.

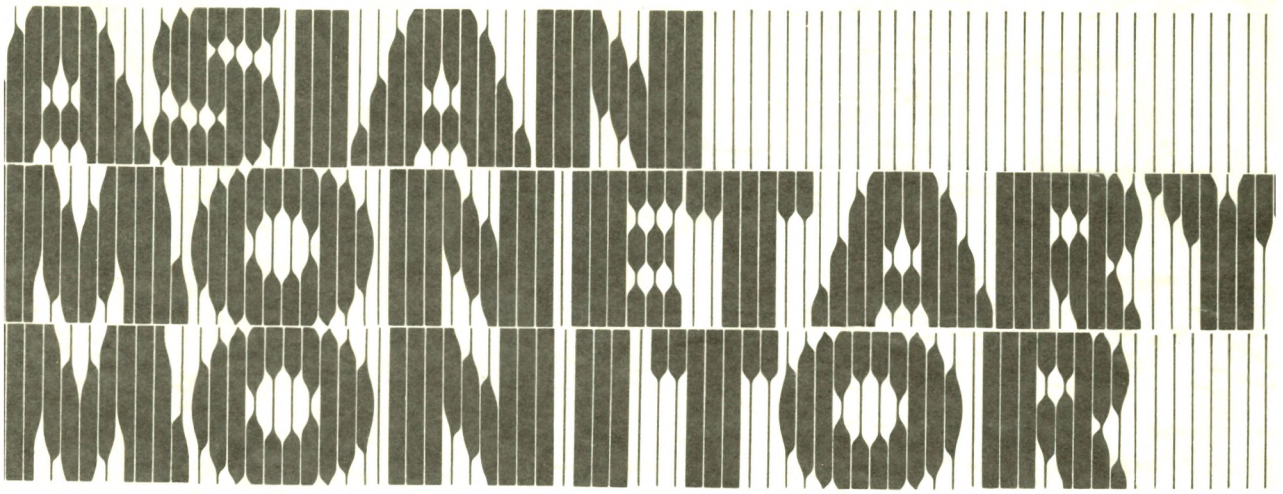
For the moment inflation at the consumer price level is relatively subdued, but it had been steadily creeping up, particularly in the cities, although it has spiked down (perhaps temporarily) in the last two months. Elsewhere there is growing evidence of overheating. First, at the raw materials level, prices have been rising strongly, although this has not yet flowed through to consumer goods. Second, the trade balance has been gradually deteriorating since the middle of 1991. Third, in the currency market the exchange rate at the swap centres -- a free market for foreign exchange earned by enterprises in excess of set quotas -- has recently been trading in the range RMB 6.80 - 7.10 versus the official rate of around RMB 5.39 per USD. Although there may be some special temporary factors accounting for this 30% depreciation (notably rumours of the impending abolition of the quota system), in general terms the weakening of the free market (swap) rate is prima facie evidence of overheating.

Assuming 1992 brings China a third successive bumper harvest, inflation may remain subdued for a few months more but it is likely to surge at some point in 1993. The only question is, at what level of inflation will the Chinese authorities finally decide to take action to restrain money and credit expansion?

CHINA: MONEY, OUTPUT, PRICES AND CURRENCY



AMM November-December 1992 Vol. 16 No.6



CONTENTS

		Page
AUSTRALIA		
Factors Inhibiting A More Vigorous Recovery by John Greenwood		1
JAPAN		
Will Fiscal Policy And Bailout Packages Rescue The Economy? by Simon Ogus		9
THAILAND		
Soft Landing in Sight by Andrew Freris		19
ECONOMIC CAPSULES		
Hong Kong: HK$ Currency in Southern China-An Updated Estimate	SLO	34
Malaysia: An Ambivalent Fiscal Stance	AFF	36

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November-December 1992 Vol. 16 No.6

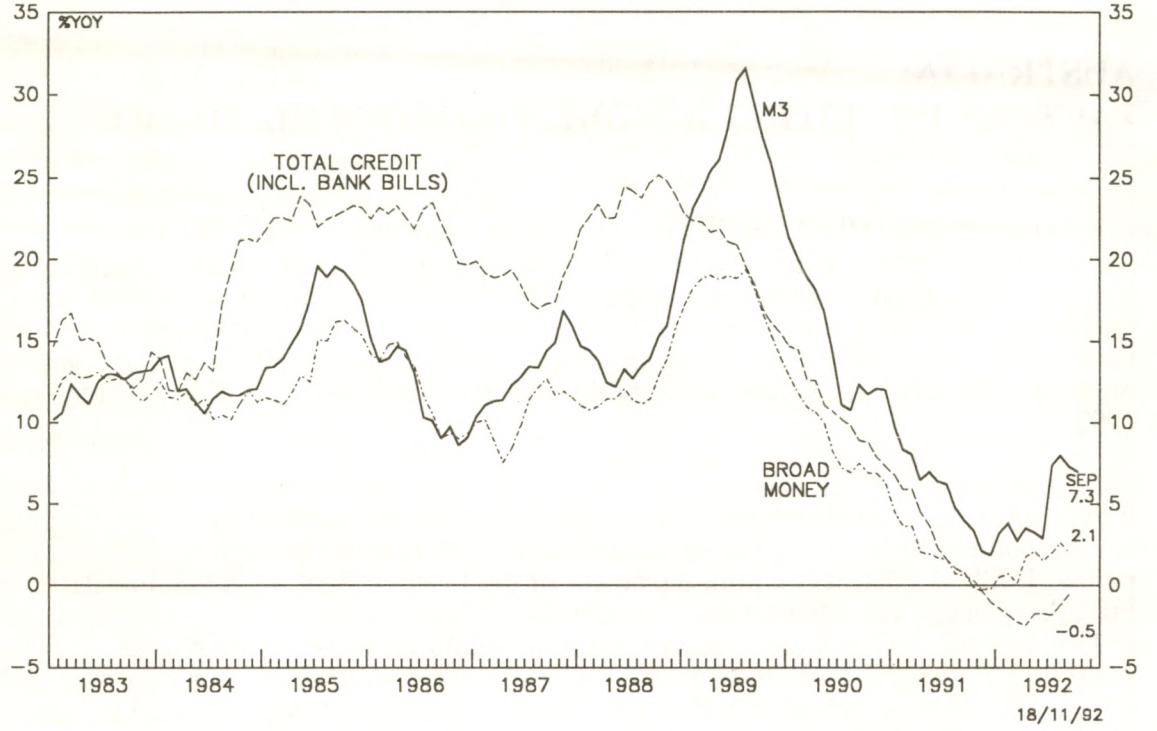
AUSTRALIA: FACTORS INHIBITING A MORE VIGOROUS RECOVERY

The recovery in the Australian economy from the recession of 1990-91 has been slow and patchy, and the general outlook for the next few quarters does not look significantly brighter. To explain the weakness of the current upturn this article highlights three factors which have combined to restrain the rate of recovery, and then considers how those same three factors might be affected by domestic and international developments next year in order to make some assessment of the performance of the economy during calendar year 1993.

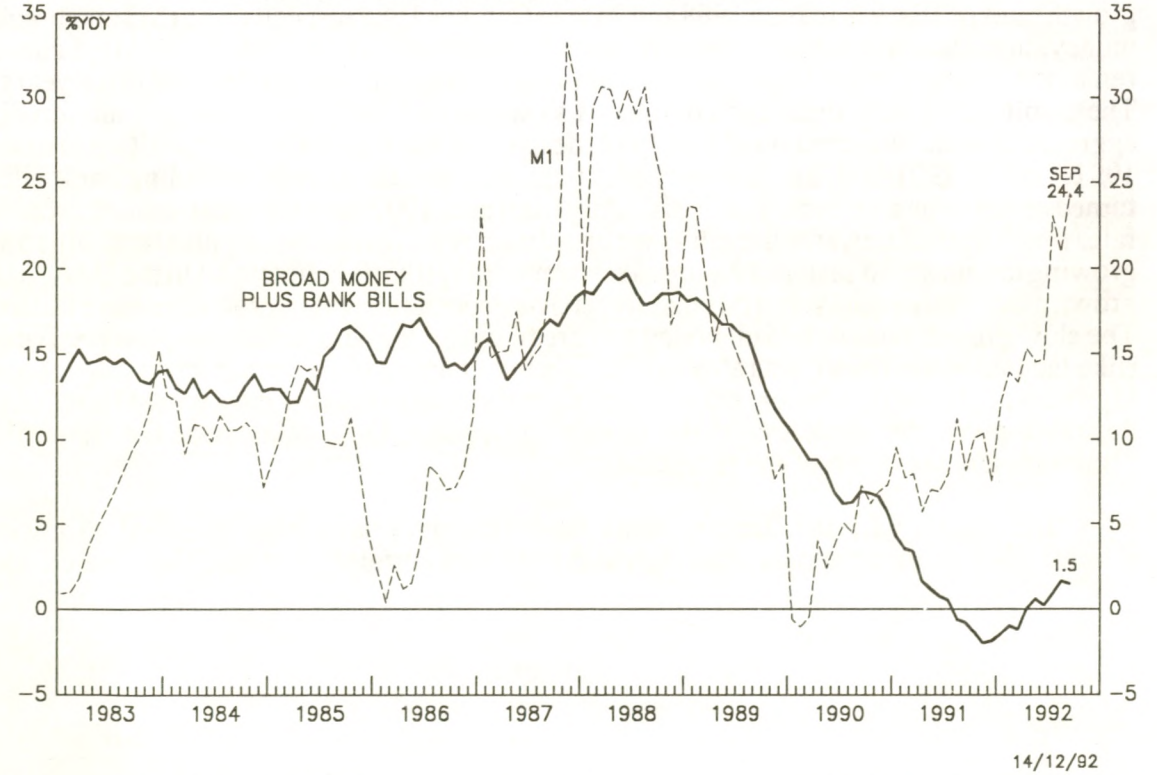
The first major factor accounting for the weakness of the Australian recovery has been the failure of the broad money and credit aggregates to give any support to purchasing power in the economy. Since Australia maintains a floating -- or at least a managed -- exchange rate policy, it follows that it is within the power of the Reserve Bank of Australia (RBA) to manage monetary conditions within broad limits. (Constitutionally the Reserve Bank has little independence from the Treasury, hence it would be more accurate to say that the Australian government has the power to set monetary conditions within whatever self-imposed constraints it chooses.) However, despite the apparent freedom to act independently the Australian authorities have in fact maintained growth rates of the broad definitions of money and credit which are exceptionally low by any historical standards. As shown in Charts 1 and 2, broad money plus bank bills and total credit including bank bills peaked at growth rates of 18-19% in June 1988 and 25% in October 1988 respectively. (M3 and broad money, also shown in Chart 1, peaked somewhat later in August 1989.) The yield curve remained inverted or flat from mid-1988 until early 1990 -- a period of almost three years. The result was a very steep and continuous slowdown of the broad monetary and credit aggregates, which has continued into 1992, despite the yield curve turning positive in mid-1991. In late 1991 both broad money plus bank bills and total credit including bank bills turned negative on a year-on-year basis. Only from mid-1992 have the broad money growth rates finally turned upwards though as yet broad money and broad money plus bank bills are growing too slowly to sustain a vigorous recovery. M1, like its counterpart in the USA, has grown much more rapidly, but this mainly reflects deposit shifts as interest rates have fallen. The slow growth rates of broad money and credit meant that the Australian Reserve Bank (like the Fed in the USA), was almost certainly maintaining short term interest rates at too high a level. In short, a faster, steeper decline in short term interest rates would have been desirable given the weakness of the money aggregates, the weakness of the domestic economy, and the depth of the recession.

The reason why the Reserve Bank (and Treasury) have been reluctant to lower interest rates more or sooner than they did is almost certainly because they feared the

AUSTRALIA: CHART 1
MONETARY GROWTH AND CREDIT GROWTH



AUSTRALIA: CHART 2
M1 AND BROAD MONEY PLUS BANK BILLS



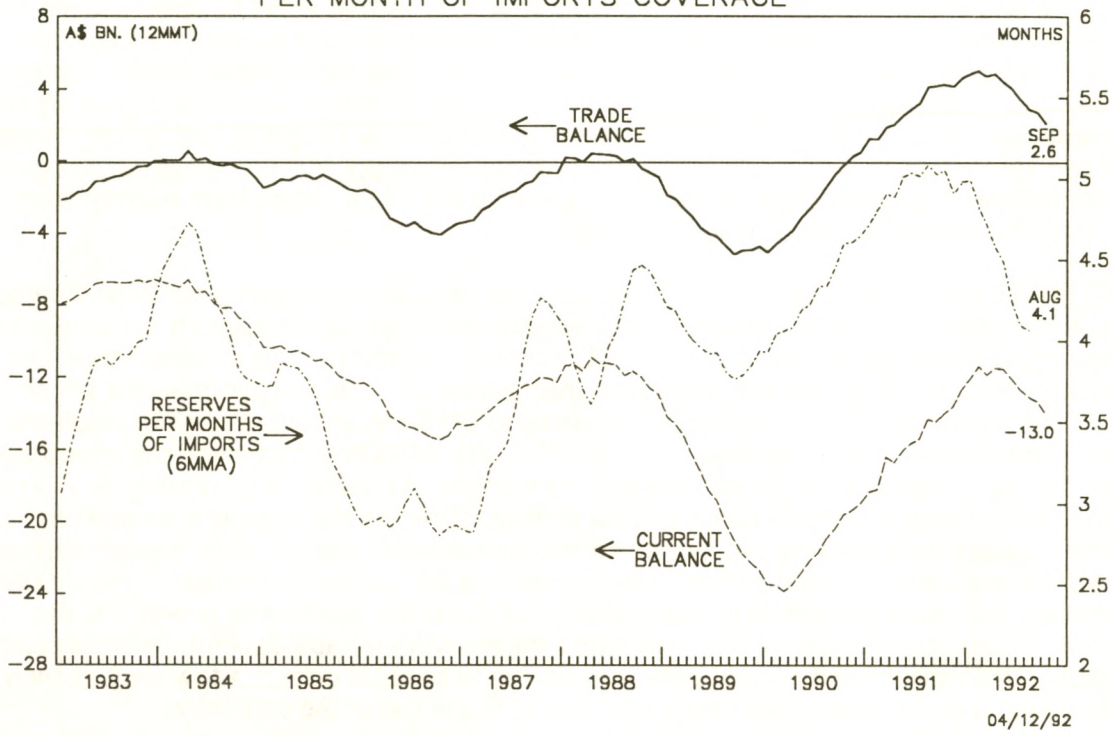
consequences of such a move for the Australian dollar. Past experiences of such episodes of currency weakness in Australia have been associated with uncomfortably high inflation. However, as long as domestic demand remains extremely weak (as it did in 1990-91), the flow-through to inflation is much less than often supposed. A good example is the case of Britain in the period 1980-83 when sterling fell from US$ 2.40 to $ 1.40 (a depreciation of 42%), yet consumer prices over the same period fell from 22% to below 4%. The conclusion is that the Australian authorities could probably afford to allow the currency to weaken further without suffering any serious inflationary consequences, and this would have enabled them to lower interest rates more, thus enabling banks to lend more and firms and individuals to borrow more, thus initiating a stronger upturn. Instead, by effectively preventing the currency from weakening, the authorities have delayed the recovery and caused it to be weaker than it otherwise might have been.

The second factor accounting for the frailty of the Australian recovery has been the weakness of balance sheets in both the corporate and household sectors. Fundamentally this problem springs from the rapidity of the credit expansion in 1987-88 and the subsequent severity of the credit squeeze. With hindsight it is easy to say that less expansion would have required less contraction, but this is nonetheless true. At the present time individuals are once again increasing their debt, borrowing mainly for housing, but in the corporate sector firms are still reducing their indebtedness as they attempt to restore healthy balance sheets. Loan write-offs by the banks exceeded A$ 6 billion in the year to September 1992, and reduced borrowings by firms brought down new business lending by a further A$ 8 billion over the same period.

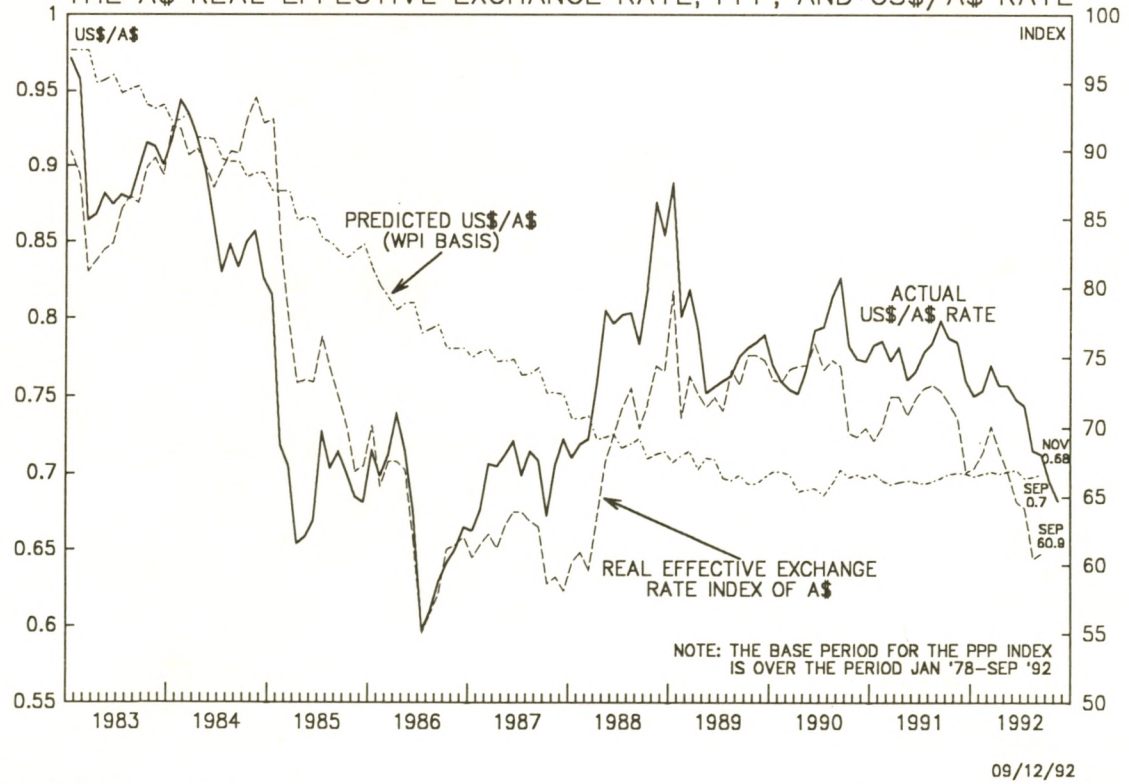
Chart 3 provides some hint of the balance sheet problem affecting the Australian corporate sector. The value of commercial properties in the central business districts of Sydney and Melbourne had roughly halved between their peak levels in 1989 and the middle of 1992. At the same time, vacancy rates for such properties have climbed to over 23% suggesting that the recovery in prices from their current levels can only be slow and painful, particularly since substantial parts of the new CBD buildings were financed by the banks. Whereas the level of employment and output in the economy (Chart 4) can be "fixed" relatively quickly by easier monetary policies, the excess capacity in the property sector is not so easily absorbed and it will require several years of good economic growth to take up the unutilised space. Balance sheet adjustments are therefore likely to be a continuing feature of the Australian economy during 1993, acting as a drag on recovery by discouraging investment in new buildings, in new industrial capacity or in inventory accumulation.

The third set of factors explaining the patchiness and slowness of the Australian recovery is the general weakness of the international economy. Historically Australia has seldom enjoyed an export-led recovery in the post-war period, largely because the country is a primary producer of agricultural commodities and minerals, demand for which does not normally strengthen until late in the normal business cycle upturn. The country has therefore traditionally depended on a domestic-led recovery in the early stages of an upswing, hence the deterioration in the trade and current accounts witnessed in the typical Australian expansion. However, in recent years microeconomic reforms and the restructuring of the economy have produced a striking improvement in the performance of manufactured exports, which should give some grounds for optimism about the feasibility of an export-led recovery. According to the RBA, manufactured exports to Asia ex-Japan grew at 27.2% p.a. in US dollar terms over the period 1986-90, exports to Japan at 29.6% p.a., exports to OECD countries in Europe grew at 21.8% p.a., and exports to North America grew at 30.1% p.a., giving an overall growth rate of 26.6% p.a., or about 15% p.a. in real terms compared with

AUSTRALIA: CHART 7
BALANCE OF PAYMENTS AND RESERVES
PER MONTH OF IMPORTS COVERAGE



AUSTRALIA: CHART 8
THE A$ REAL EFFECTIVE EXCHANGE RATE, PPP, AND US$/A$ RATE



years. Note, however, that once the yield curve became positive from mid-1991 onwards, declines in short term interest rates (Chart 5) led to a weakening in the spot exchange rate to the point where the currency has for the first time in five years become undervalued relative to its purchasing power parity. In view of the (normal) tendency for a currency to fluctuate on either side of its purchasing power parity during the course of the business cycle it would seem quite reasonable at the current time to allow the currency to weaken somewhat further, thus helping to improve Australia's competitiveness, and thereby to assist export performance and add strength to the economic recovery. (This is not so different from the policy adopted recently by the U.K. government when it devalued sterling from an overvalued level against the Deutschemark.)

SUMMARY AND FORECAST: The Australian economic recovery has been slow and patchy. The three main reasons for the weakness of the recovery are (i) the continuing tightness of monetary policy as reflected in very slow growth rates of broad measures of money and credit, (ii) persistent balance sheet problems in the corporate sector which are a hangover from the go-go expansion years up to 1988-89, but are nevertheless inhibiting new investment and expansion, and (iii) the lack of demand in overseas economies, particularly Japan, Europe and to a lesser extent N. America. The remedy is to lower Australian interest rates a notch or two further, allowing the currency to weaken, and encouraging bank lending and money growth to accelerate slightly. The weaker currency will enhance international competitiveness without increasing CPI-inflation, while faster money and credit growth will create additional domestic purchasing power. Unless the Australian authorities adopt these measures, the recovery is liable to continue on its present path -- below par for a normal upswing, narrowly focused on just a few sectors such as housing, and percolating outwards only slowly to the rest of the economy.

JAPAN
WILL FISCAL POLICY AND BAILOUT PACKAGES RESCUE THE ECONOMY?

Introduction

After claiming for many months that the slowdown in the economy was merely a function of "inventory adjustment", the Japanese authorities have begun to recognise the extent of their problems and have started to act. Under pressure from the Ministry of Finance (MOF) and politicians alike, the Bank of Japan (BOJ) has (somewhat reluctantly) cut its discount rate 5 times since June 1991, from a peak of 6% to 3.25% currently. In addition, a supplementary budget worth Yen 10.7 trillion or 2.3% of GNP has been announced, and plans for an agency to buy up banks' non-performing property-related loans, akin to America's Resolution Trust Corporation (RTC), have been unveiled. The question remains as to whether these measures will be sufficient to arrest the decline in an economy set to record negative real GNP growth year-on-year for the first time since 1974. This article argues that the banking system is in no position either to realise major capital losses, or to extend credit to the government without further depressing private sector credit growth. BOJ monetisation of public sector debt, in one form or another, will ultimately be required. This would boost money supply growth and have the effect of lowering short term interest rates. However, in the interim, the authorities believe that they have done enough and are content to sit back for perhaps a further 3-6 months and wait for their measures to take effect. This implies further economic deterioration over the next 12-15 months, as the effects of any policy reversals 6 months hence will not filter down to the real economy for a further 6-9 months.

The Effectiveness of Fiscal Policy: A Mixed Record

Since the mid-1970s, Japan has introduced a number of supplementary budgets to boost economic activity, but with mixed results. Between September 1976 and September 1977, at least five sets of fiscal measures were enacted (see AMM Vol. 1 No. 1), but the response of the economy was at best muted. However, the supplementary budget of Fiscal 1987 (see AMM Vol. 12 No. 1) envoked a far more vigorous expansion. One can therefore surmise that the introduction of a fiscal package is not a sufficient condition for economic acceleration; one also needs to examine the stance of monetary policy. The failure of the 1976-77 packages can be attributed to the tight monetary policy conducted by the BOJ over the same period. Real M2+CD growth was kept below 5% (Chart 1) and was decelerating until mid 1977. In contrast during Fiscal 1987, real M2+CD growth was around 10% and was fuelling the bubble economy.

The MOF has chosen to rely on the 1987 episode in predicting the outcome of the August 1992 Yen 10.7 trillion package (Table 1). The government expects these measures to have an overall multiplier effect of around 1.29 (ie for every Yen 1 spent, Yen 1.29 will be added to nominal GNP) which implies a total package value in the region of 3% of GNP. This figure is based on the 1.39 multiplier of 1987 which the Economic Planning Agency (EPA) believes applies to around three-quarters of the package. The remaining quarter involves land purchases and operating costs which (according to the EPA) have no multiplier effect (ie a multiplier of 1). However, the key difference between the current package and that of 1987-88 is that today money growth is at historical lows.

JAPAN: CHART 1
REAL M2+CDs AND REAL GNP

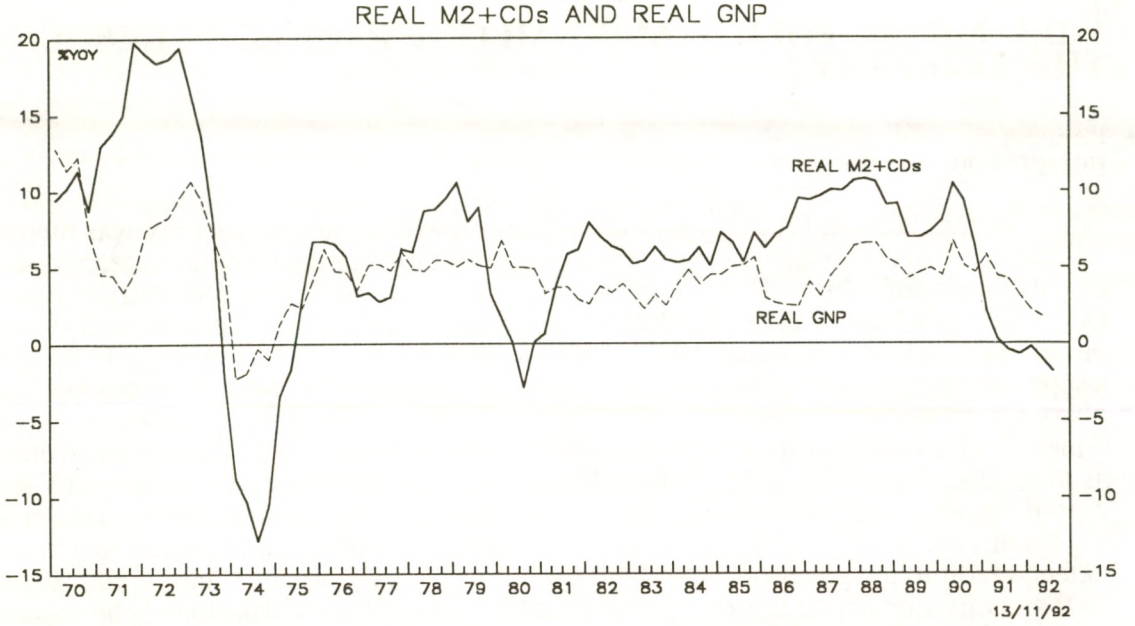


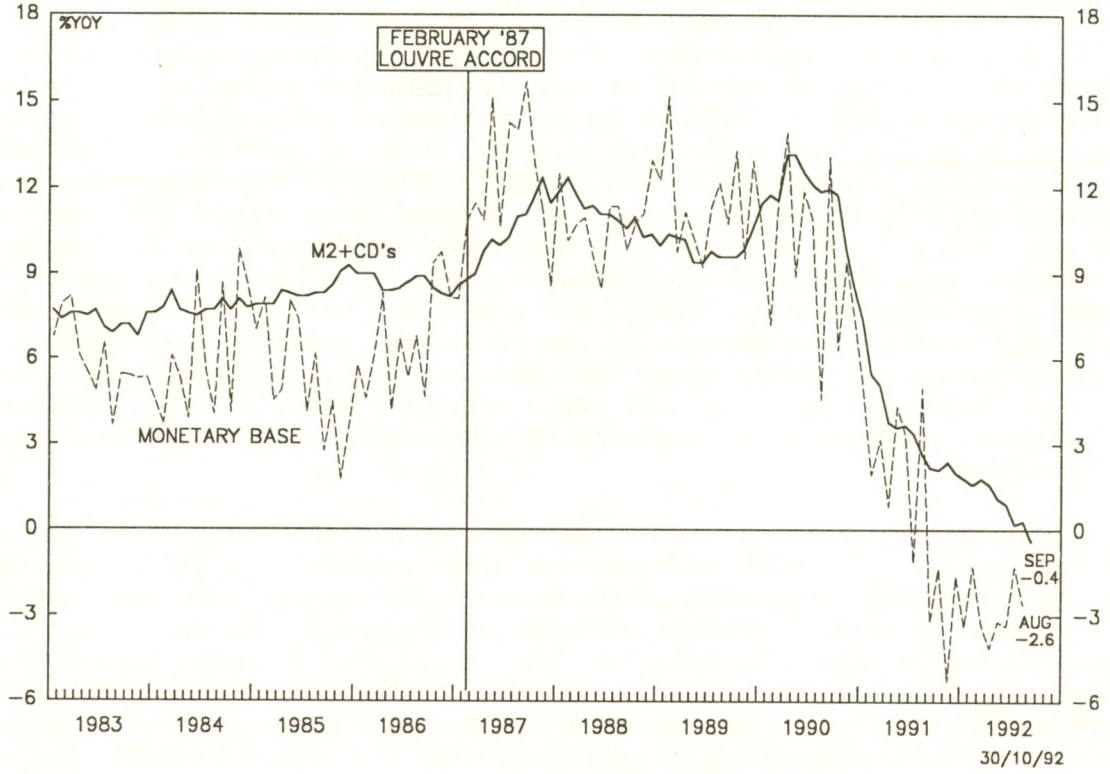
Table 1

The August 28th 1992 Supplementary Budget (Yen trillion)

Central Government Public Works	3.40
Local Government Public Works	1.80
Disaster Recovery Works	0.50
Education and Research	0.55
Public Residential Construction	0.80
Local Government Land Purchases	1.55
Government Loans to Business Investment	2.10
	10.70

The BOJ's most closely watched measure, M2+CDs contracted 0.4% year-on-year in September -- the first decline since records began (Chart 2). Monetary base growth has also been negative since late 1991. The package of measures, as explained later, will boost money growth to a certain extent, but not to the 6-8% levels needed to encourage real economic expansion. This is because banks are in no position to expand their loan books significantly. Although private sector loan demand is certainly weak, increased lending to the government will likely crowd out much of the private sector. This implies a multiplier closer to 1.0.

JAPAN: CHART 2
MONETARY GROWTH



The Japanese Banking System and the Funding of the Package

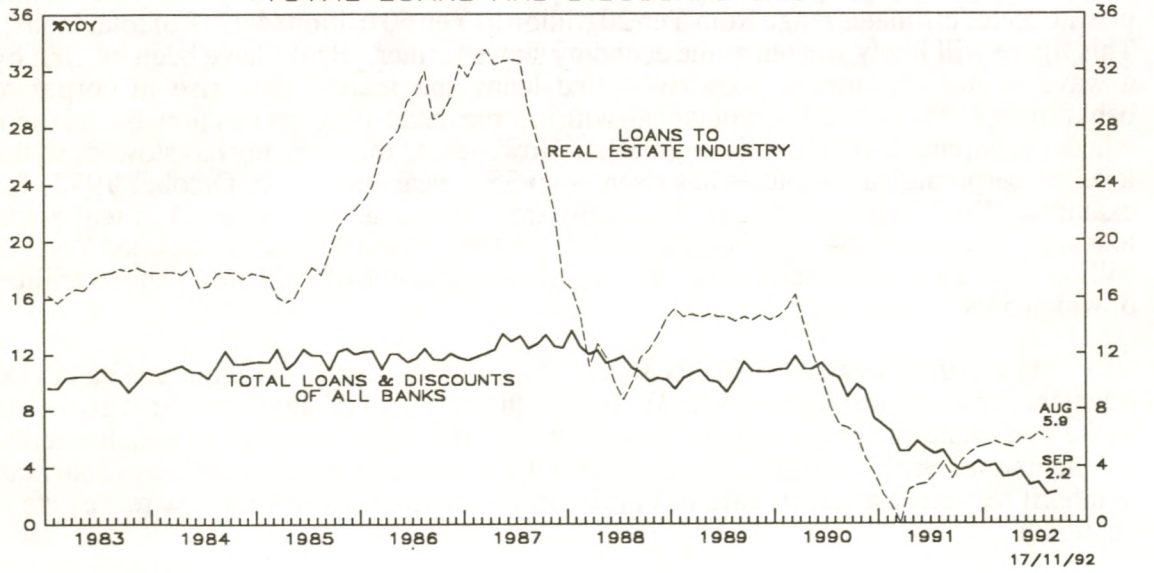
Disclosure requirements for Japanese banks are minimal so the full extent of the system's non-performing loans is far from clear. The MOF has announced that the 21 biggest banks had Yen 12.3 trillion of non-performing loans at the end of September 1992, up from Yen 8 trillion 6 months previously. In reality, the situation is probably much worse and private sector estimates range from Yen 20 trillion to Yen 60 trillion (4-13% of total loans). This figure will likely worsen as the economy slows further. Banks have been hit first by a wave of non-performing property-related loans and second by a rise in corporate bankruptcies. The property sector is dealt with in more detail in the next section, but it is here where the unreported bad-debts are greatest. However, as the economy has slowed, so the level of corporate bankruptcies has risen -- up 35% year-on-year in October 1992, for example. "Non-bubble company" bad debts are now accelerating faster than real estate loans, and account for 54% of the total debts of bankrupt companies which reached Yen 5.2 trillion in the first 9 months of 1992. The figure for the whole of 1991 was Yen 8.1 trillion of which 55% were property-related.

Given their weakened balance sheets, it is of little surprise that Japanese banks are reluctant to extend new loans (Chart 3). In fact, the only area of significant loan growth is to the real estate sector and this reflects short term financing extended to match interest payments due. Banks are taking the view that it is better to keep these companies afloat than to inherit real estate assets that are still falling in value. Loan growth for new real estate is negligible.

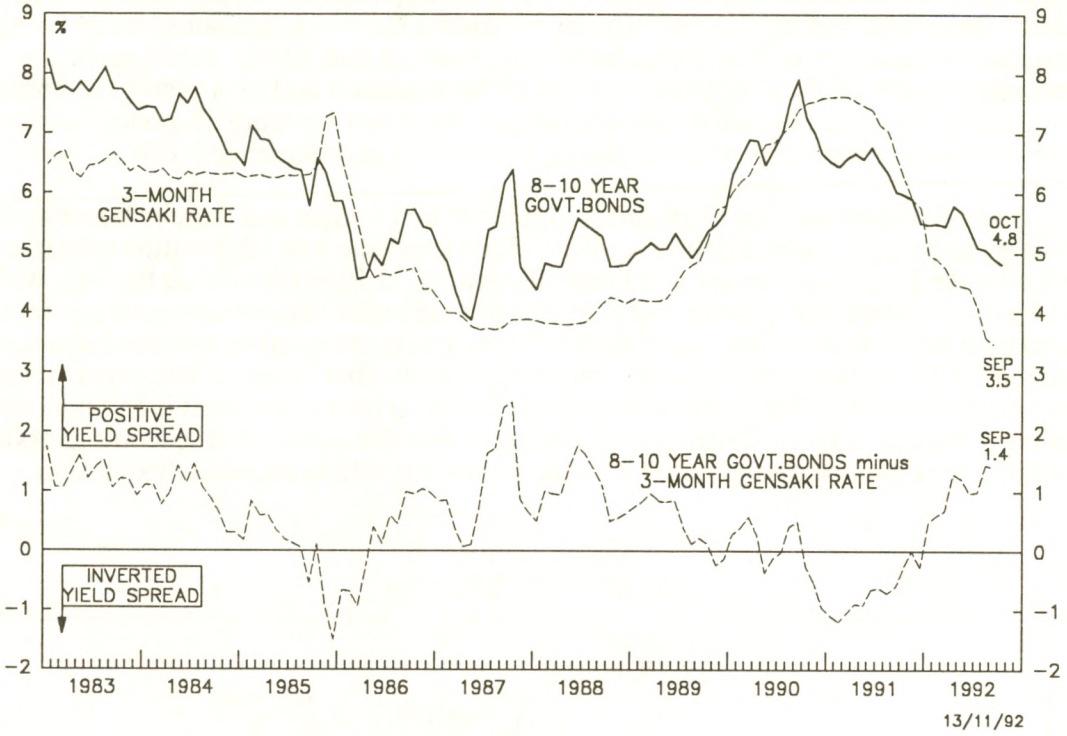
As well as restricting the growth of their loan books, banks are trying to rebuild the growth of their balance sheets by widening margins and to the extent that they are able to, by "riding the yield curve" (Chart 4). Nevertheless the scope for banks to borrow cheaply at the short end of the curve and lend more expensively and long to the government -- a pattern seen in the US in recent years -- is limited by restrictions on their source of funds. For example, City Banks mostly fund in the short term money markets while their long term lending rates are priced off their short term prime rate. Therefore, cuts in short rates also pull down their long term prime rates. Similarly, Long Term Credit and Trust Banks mainly fund and lend both at the long end of the yield curve. A steeply positive yield curve improves the position of a limited portion of banks' mismatched fixed price assets, but restoring financial integrity by this method will take a long time. Banks have also increased their issues of subordinated capital -- Yen 1.5 trillion in the first half of 1992 -- which can be counted as tier II capital for BIS capital adequacy ratio (CAR) purposes. Tier II capital also includes unrealised stockmarket gains which have been disappearing as equity prices fall thus undermining CARs. One study estimates that the raising of Yen 9 trillion of subordinated capital would eliminate the need to hold any unrealised stockmarket gains for CAR purposes.

It is all very well for banks to issue paper but they must also find buyers and for this they will turn to the postal savings system and the life insurance industry. These are also the entities through which the government intends to fund the majority of its supplementary budget, as they have seen huge inflows of money over the last year. The inflow into postal savings -- Yen 24 trillion since the end of 1990 -- has attracted much attention and some commentators have argued that this is a major factor behind the weakness of M2+CDs (postal savings deposits are not included in this measure of money). Savers have been attracted to the post office (Chart 5) by the superior flexibility of accounts that it offers. A minimum deposit of only Yen 1,000 allows investors to lock into high fixed rates for as long as 10 years, and withdrawals from time deposits are without penalty after 6 months. Interest rate differentials against equivalent accounts at banks, however, are at most 0.05 % and rates have tended to follow bank rates down with only a very short time lag.

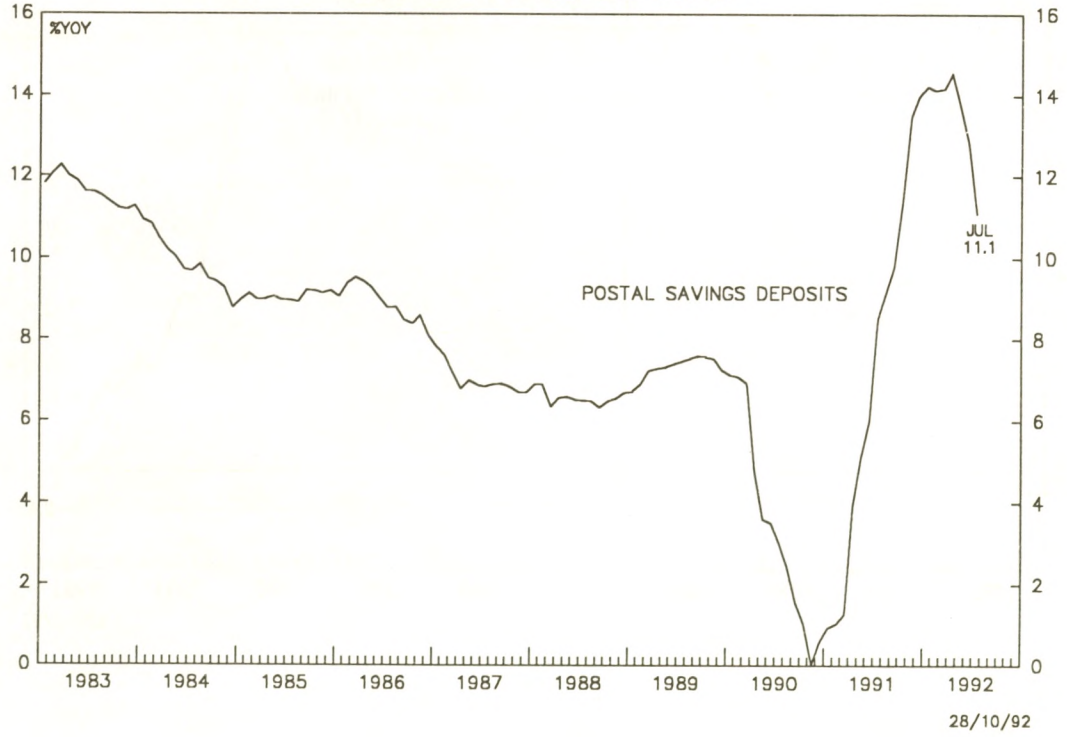
JAPAN: CHART 3
TOTAL LOANS AND DISCOUNTS GROWTH



JAPAN: CHART 4
INTEREST RATES AND THE YIELD SPREAD



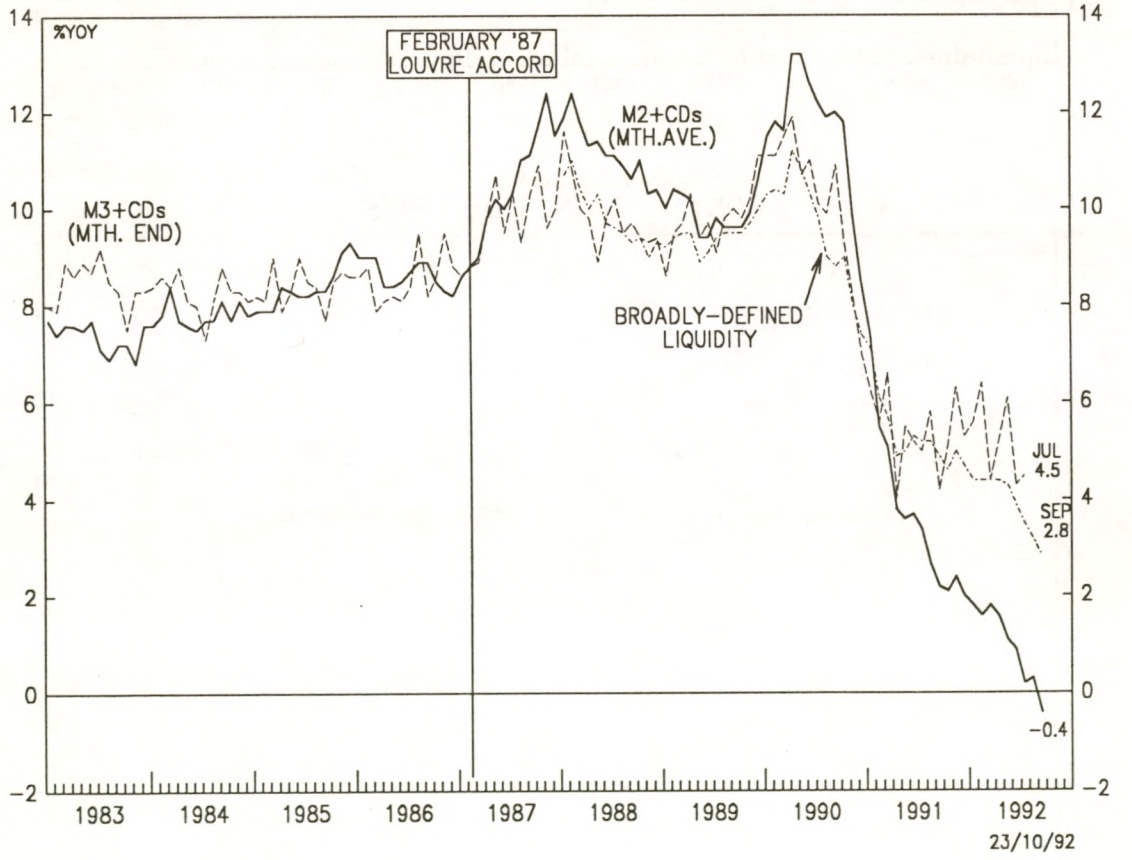
JAPAN: CHART 5
POSTAL SAVINGS DEPOSITS



The rate of postal savings deposit growth has been the major reason why M3+CD growth has not turned down as far as M2+CD growth (Chart 6). Postal savings deposits account for around one half of the difference between the two aggregates; the remainder comprises various deposits of agricultural cooperatives and labour credit associations. However, growth of these deposits appears to have peaked and as a result the broader aggregates have started to turn down once again. Whatever measure of money one looks at, growth rates remain shy of the levels required to fuel economic recovery.

The government hopes to fund its supplementary budget and thereby boost money supply by tapping this vein of deposits. Yen 7.3 trillion of the Yen 10.7 trillion total is to be funded by the Fiscal Investment and Loans Program (FILP) -- the vehicle through which postal savings can be lent to government and the private sector. Postal savings are generally placed with the Trust Fund Bureau of the MOF which in turn extends loans to or buys bonds from the FILP. Although this boosts money supply in the first instance, banks may try and compensate by further restricting loan growth. Thus, if the government is relying on the banking system to extend infrastructure and other budget related credit to subcontractors and the like, it may well be disappointed with the ultimate resulting monetary expansion.

JAPAN: CHART 6
MONETARY GROWTH



Banks, the Real Estate Sector and the Japanese RTC

In recent weeks, the details of Japan's version of the RTC have been unveiled. However, in the current form proposed, this amounts to little more than an accounting exercise. Banks will be allowed to swap a non-performing loan to an existing corporation with a non-performing loan to the new agency. It does not address the problem of the disposal of the underlying asset as banks will still not be in a position to realise major losses. Table 2 outlines the workings of the RTC.

Table 2

The RTC Bailout Scheme

Stage 1: The bank lends Yen 100 to a real estate developer to buy land. The loan is funded from the bank's deposit base and collateralised against the land's purchase value.

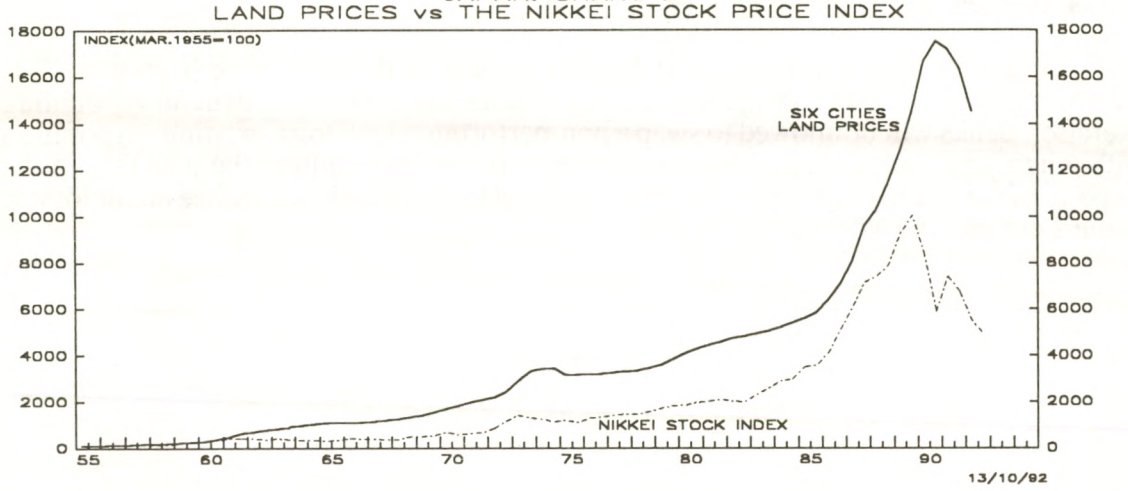
Stage 2: Land prices fall and the developer can no longer service his loan.

Stage 3: The bank extends a loan to the RTC for an amount determined by the RTC's appraisal committee, say Yen 80. The RTC uses these funds to purchase the original loan from the bank, which then takes a Yen 20 loss and an immediate tax write-off.

Stage 4: The RTC instructs the developer to sell the land which nets Yen 70 in the open market. The developer pays back the loan of Yen 80 to the RTC and takes a loss of Yen 10. If the land is sold for greater than Yen 80,any excess is returned to the bank to offset its initial capital loss.

As outlined above, the RTC will divide capital losses between developers and banks at no cost to the public. In reality, Stage 4 is unlikely to occur at the current time because the losses would be too great for either party to bear. Chart 7 shows that although land prices have fallen perhaps 20% in the major cities they remain far above their historical trend. Furthermore, they would have fallen further but for a drying-up of transactions. Companies and banks are preferring to sit on (and not disclose) unrealised losses in the hope that prices will start to rise again. However, prices are still well above the levels at which the average Japanese can afford to buy, and it is probably necessary for this part of the bubble economy to deflate further. At the very least, prices will remain at current levels until affordability ratios can return to near normal levels via income growth -- a process that will take a number of years. To speed up this process will require the use of public money to absorb some of the banking and real estate industry losses. This will be a difficult policy to implement for political reasons as the Japanese public will be unwilling to see bank shareholders and the bankers escape without loss. However, a compromise (involving perhaps a few high profile resignations, salary cuts, bankruptcies etc.) which results in land prices becoming more affordable without causing financial system meltdown, should be able to be reached.

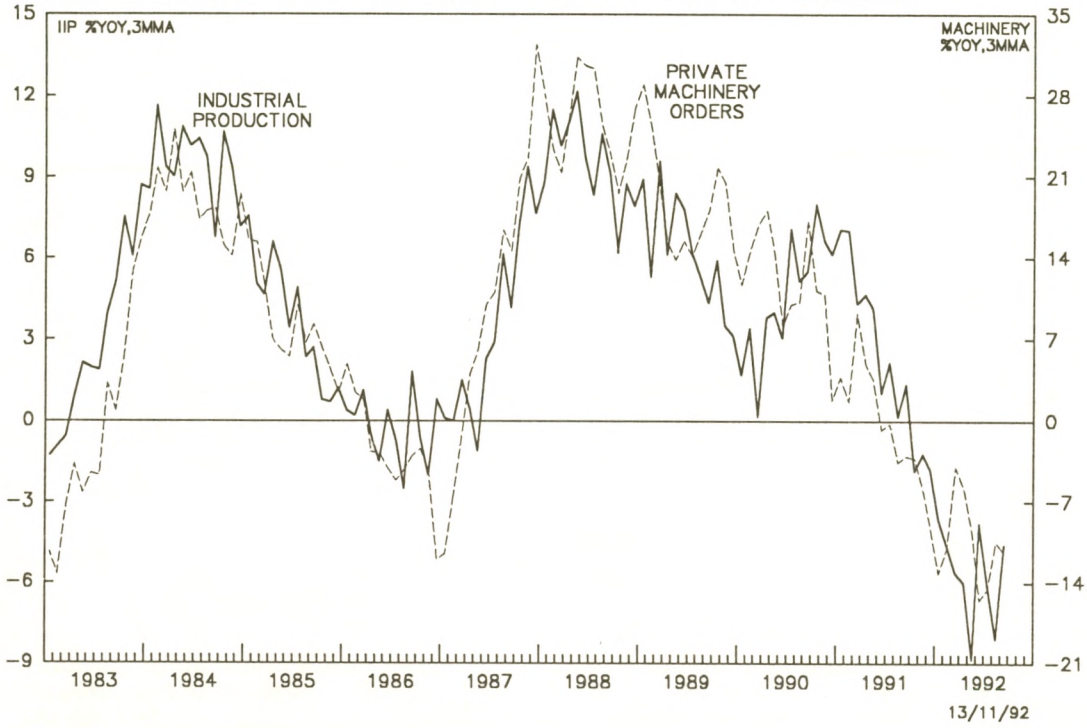
JAPAN: CHART 7
LAND PRICES vs THE NIKKEI STOCK PRICE INDEX



FORECAST AND CONCLUSIONS

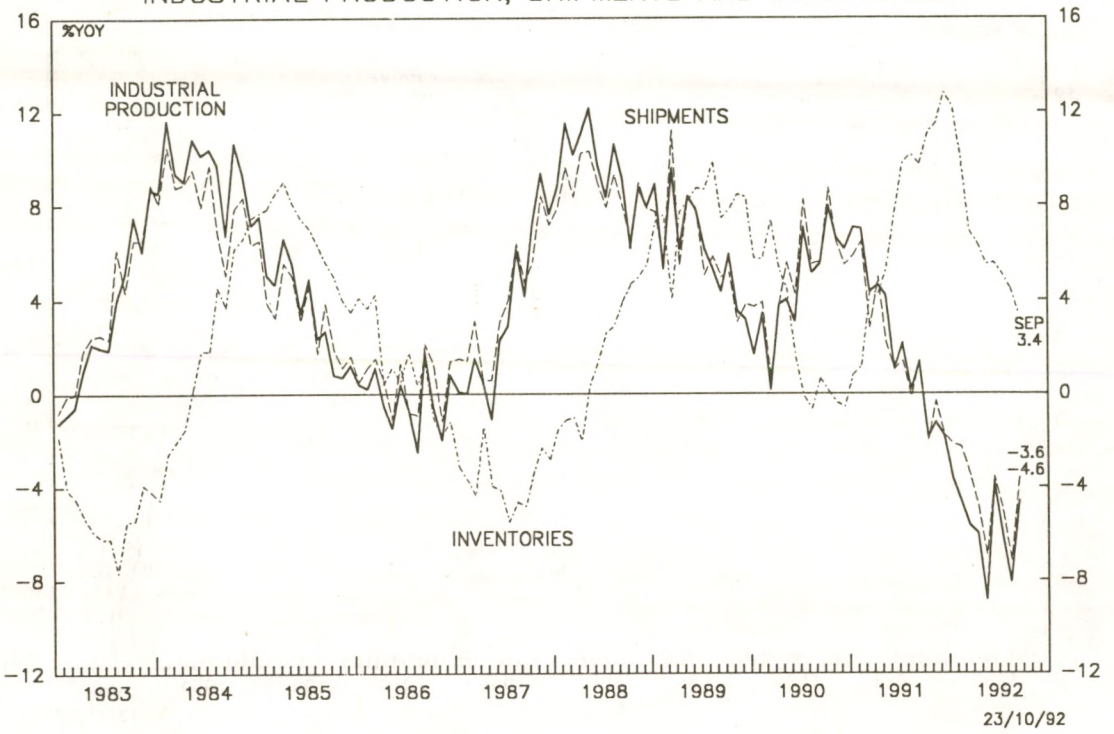
The revitalisation of the banking system and the asset markets is essential to facilitate the reliquification of the economy. This process would be aided by lower short term interest rates and a steeply positively sloped yield curve that allows banks a little extra scope to rebuild their balance sheets. Nevertheless, in an environment of asset price deflation, corporate bankruptcy and balance sheet contraction, positive yield curve steepness is not a sufficient condition for monetary growth and thus economic expansion. The US experience suggests that banks are likely to offset any increases in lending to the government with a contraction in private sector lending. Few people would suggest that private sector investment or consumer finance demand is strong. The former has slowed sharply from the peak of the late 1980s impacting on industrial production (Chart 8); the latter will be constrained by an evaporation of bonuses, negative wealth effects and fears of redundancy, reflected in the tumble in retail sales growth (Chart 9). Nonetheless companies will still require a certain level of financing for inventories, working capital etc. (Although the rate of inventory accumulation peaked at the end of 1991, inventory levels are still equivalent to almost 5% of GNP (Chart 10). In other words, inventories are sufficient to meet an entire year's growth of demand, implying that any production rebounds will be far from strong.) To maintain at least a minimum of corporate liquidity will require money growth of around 6% and this is what government action to date has failed to address. The introduction of supplementary budgets and the setting up of an RTC is a step in the right direction, but these measures will fall short of their aims unless public money is utilised. Funding needs to be provided by the BOJ thereby boosting money supply via monetisation. Given (1) the BOJ's hardline anti-inflation stance and (2) the authorities' belief that the measures introduced will turn the economy, this currently seems unlikely although it has not been ruled out altogether. However, inflation is likely to fall sharply (and with it bond yields) over the next 6 months -- wholesale prices have been contracting year-on-year since late 1991 -- as a result of extraordinarily low money growth and weak domestic demand (Chart 11). Moreover, it will become clear to the authorities that the economy is not responding and is in fact deteriorating further. BOJ monetisation of public sector debt is unlikely to occur until probably the second quarter of 1993 and this should signal the bottom in the Japanese economic cycle. Unfortunately, given the lag structure of monetary and fiscal policy, the effects of any policy reversals 6 months hence, will not impact the real economy for a further 6-9 months, i.e. until late 1993 at the earliest.

JAPAN: CHART 8
INDUSTRIAL PRODUCTION AND MACHINERY ORDERS

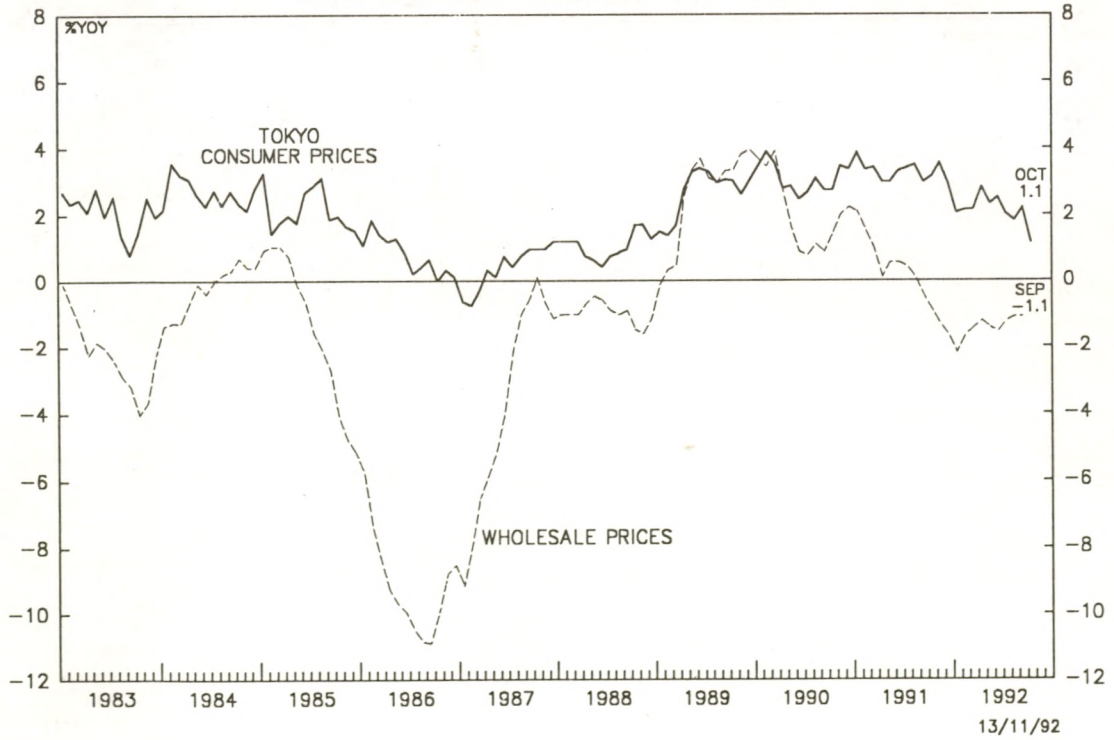


JAPAN: CHART 9
NOMINAL RETAIL SALES

JAPAN: CHART 10
INDUSTRIAL PRODUCTION, SHIPMENTS AND INVENTORIES



JAPAN: CHART 11
CONSUMER AND WHOLESALE PRICES



THAILAND
SOFT LANDING IN SIGHT

Introduction

The political changes in Thailand, starting with the massacre in Bangkok during May 17-19th 1992 and ending with the peaceful and democratic elections on 13th September 1992 detracted some attention from important economic developments. During 1992 there was a growing concern that the Thai economy would collide head on with the twin constraints of a deteriorating current account deficit, which could force a baht devaluation or cause high interest rates, and with rising inflation which would be incompatible with a pegged currency. The economy, in terms of GDP growth, had peaked during 1988, but inflation, which had accelerated from 1988 Q4, remained high and showed no declining tendency until well into the middle of 1991 (Chart 1). The climate of political instability which had started with the military coup of February 1991 did not help the situation, and neither did the Gulf War of that year which impacted the tourist and hotel trade.

This article explores and analyses the economic and financial developments which will allow the Thai economy to continue to enjoy in 1993 a high growth rate without accelerating inflation and without the current account deficit necessitating tougher monetary and fiscal policies.

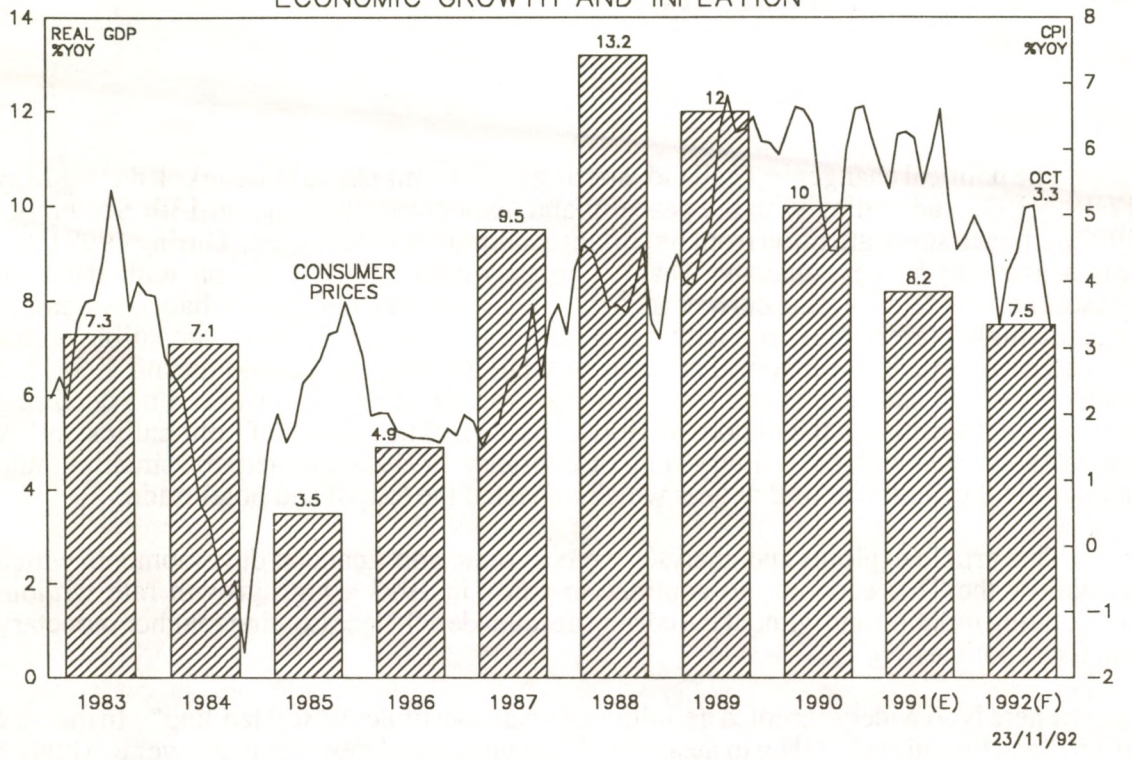
There is no widely accepted definition of what constitutes a "soft landing". In the case of Thailand this might be taken to mean that the economy will move from a lower to a higher growth rate without any major policy adjustments.

Aspects of Financial Stability

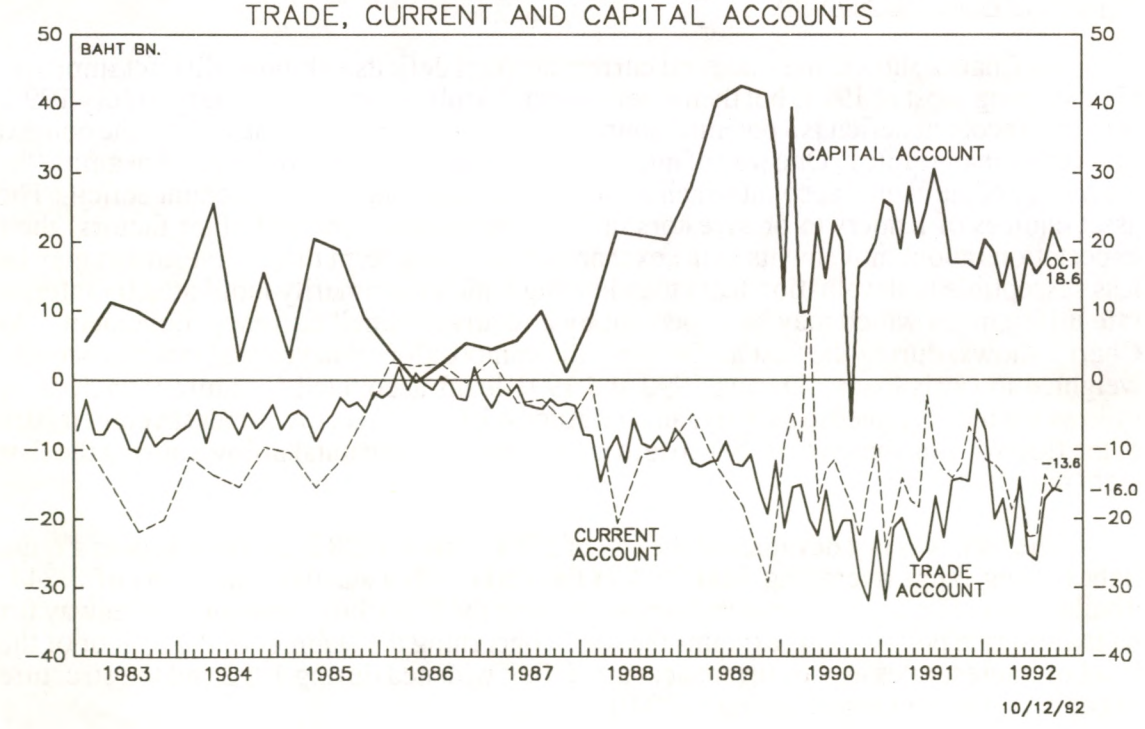
As Chart 2 shows, the trade and current account deficits exhibited distinct improvements during most of 1991, but then deteriorated sharply again from January to July 1992. A current account deficit is a potential source of economic instability but only in the context of fixed exchange rates. One way of quantifying an aspect of this problem is to examine the behaviour of the capital account which is the counterpart of the current account deficit. The asset choices of lenders to or investors in Thailand reflect, amongst other factors, their expectations about movements in the exchange rate. Long term direct investment may be less susceptible to devaluation fears than lending which is primarily motivated by interest rate differentials which may be wiped out by a relatively small currency movement. As Chart 3 shows, during the first half of 1991 the composition of net capital inflows became weighted towards loans. During 1990 and 1991 loans accounted for more than 50% of inflows but they declined to 37% by January-August 1992. Direct investment averaged 20% of the flows during these years, but rose to nearly one third of capital inflows during the first eight months of 1992.

The baht was last devalued at the end of 1984. Since 1988 it has been kept in a quite tight trading range averaging Baht 25.4 to the USD with a standard deviation of 0.244. Thailand has effectively pegged its currency against the USD thus allowing little leeway for its interest rate policy. This explains the fears concerning the stability of the baht or of the level of interest rates as the current account deficit widened during 1992 and the structure of capital inflows changed during 1990-91.

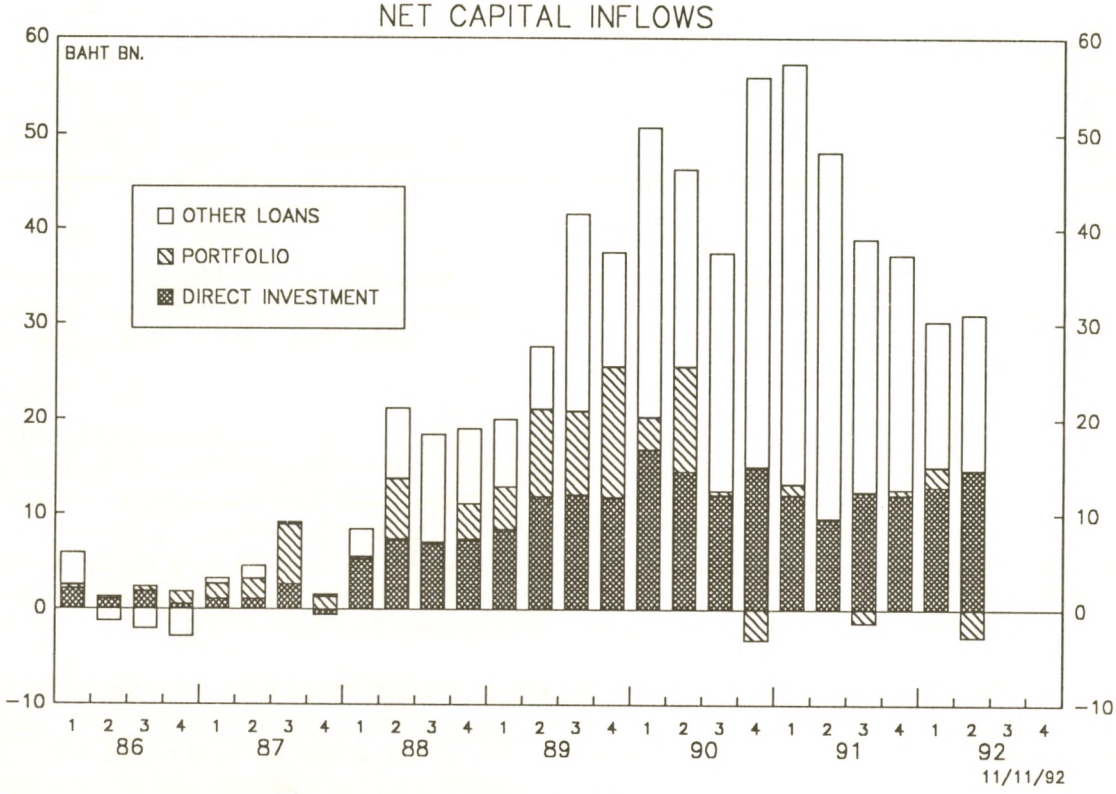
THAILAND: CHART 1
ECONOMIC GROWTH AND INFLATION



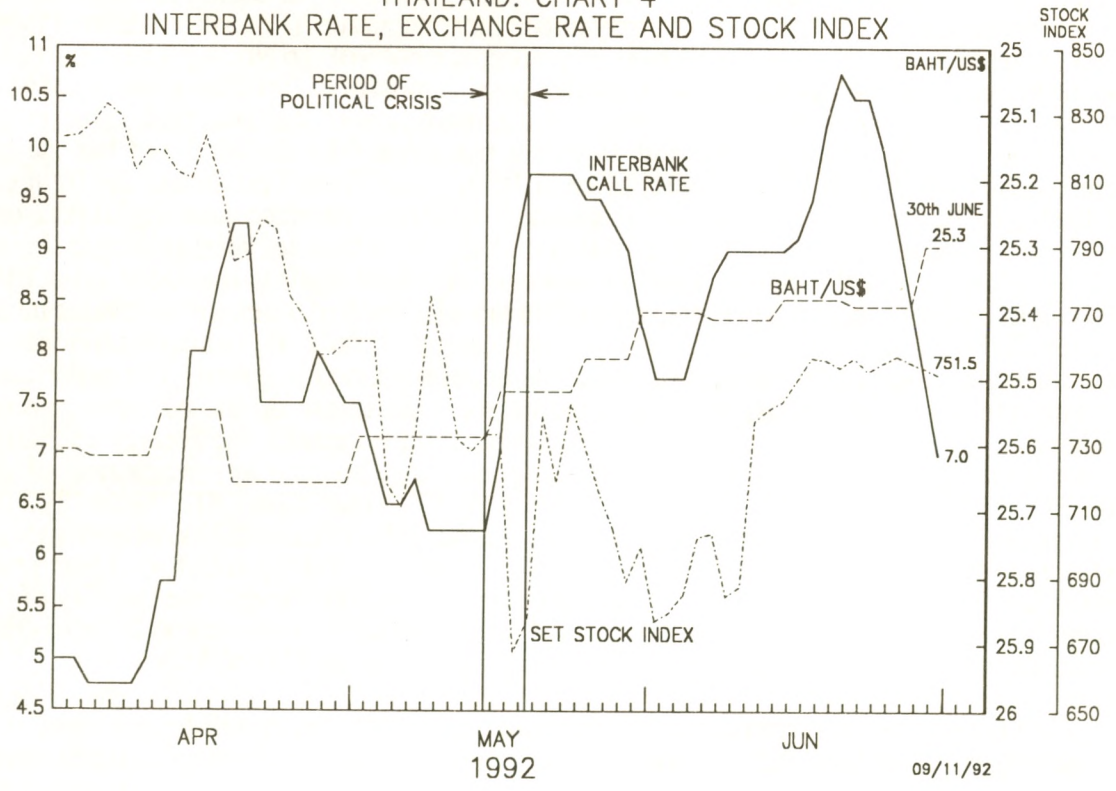
THAILAND: CHART 2
TRADE, CURRENT AND CAPITAL ACCOUNTS



THAILAND: CHART 3
NET CAPITAL INFLOWS



THAILAND: CHART 4
INTERBANK RATE, EXCHANGE RATE AND STOCK INDEX



The violent events of May 17-19 1992, when the army suppressed pro-democracy demonstrators and necessitated the personal intervention of the King to defuse the situation, had little permanent impact on the money and equity markets. As Chart 4 shows, the market which recovered fastest was the stock market, whilst it took more than one month for the interbank call rates to fall back to approximately near their pre-crisis levels. The baht, whose stability was under question, hardly moved -- depreciating over the crisis by 0.4 of one percent. As indicated the equity market was back to its pre-crisis level within couple of days, although it fell back in the succeeding weeks until, roughly, the middle of June.

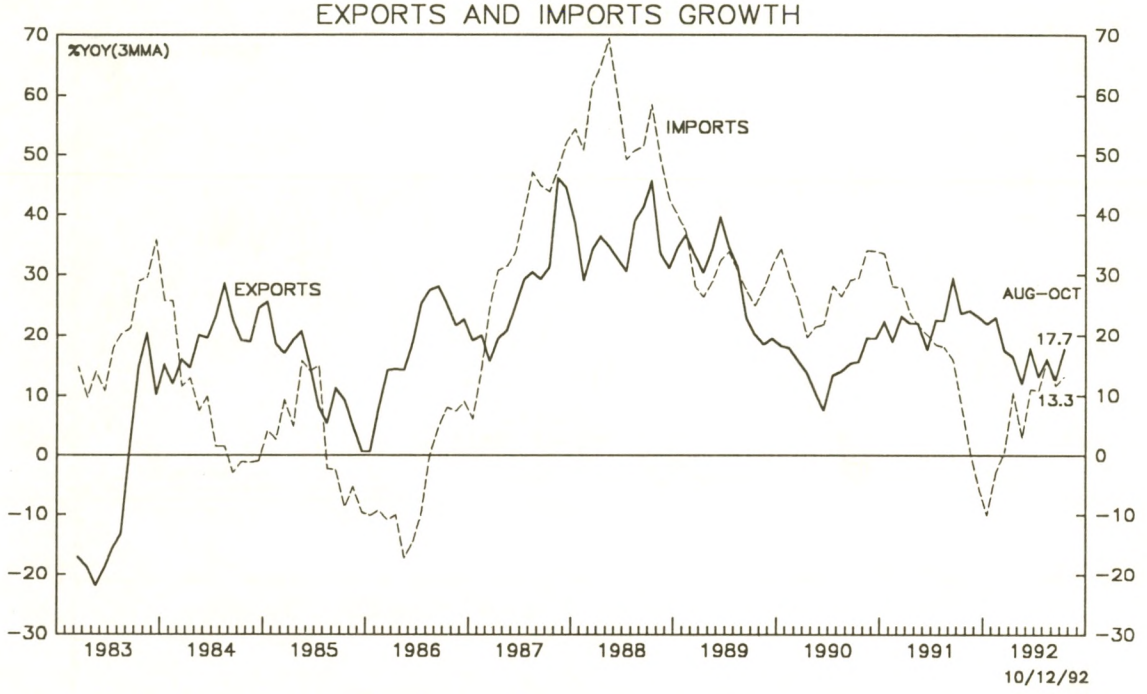
Surviving a crisis, however, is not necessarily a guarantee of the long term viability of the pegged exchange rate. As Chart 2 showed, the current and trade accounts deficits will need several more months of clear improvements in order to show that the bottoming out during July 1992 was not just a temporary phenomenon.

The rate of growth of imports accelerated from the start of 1992. The best that can be said for exports growth is that the slowdown has been arrested for now (Chart 5). Export growth on a monthly year-on-year basis (rather than the 3MMA shown on Chart 5) is now faster than that of imports. Using Purchasing Power Parity estimates based on wholesale prices the baht is slightly undervalued, but by less than 3%. The index of competitiveness (Real Effective Exchange Rate) has decreased almost contiuously since 1991 H.1 indicating that Thai exports have become progressively less competitive (Chart 6).

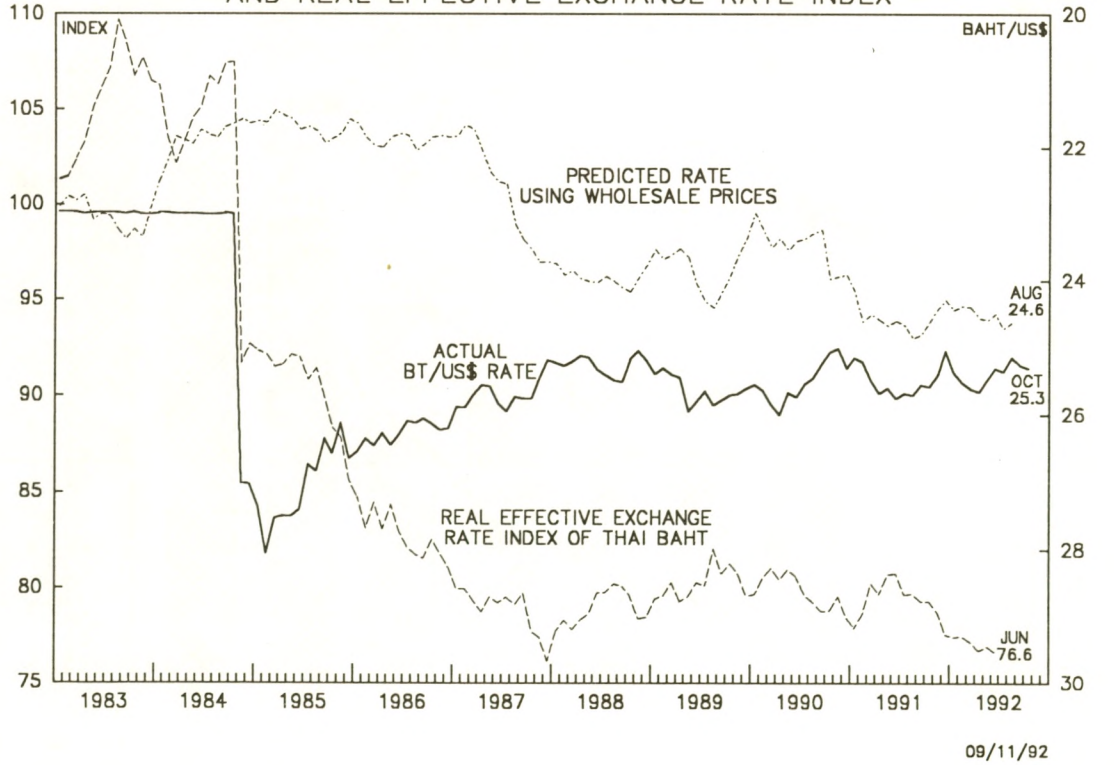
There is, however, some additional evidence which casts a different light on the external competitiveness of the Thai economy. In general, comparisons of price indices which are based on non-tradeable goods or services (ie goods and services not exported or consumed by nonresidents) may provide a distorted image of external competitiveness. Even PPP or real effective exchange rate calculations which use wholesale, rather than the less representative retail price index, may not be more accurate. (For a discussion of these technical but important issues see AMM July-August 1992 Vol. 16 No. 4.) The export unit value index is a proxy for export prices, thus by-passing most of the problems associated with domestic price indices. As Chart 7 shows the growth rate of the Thai unit value index increased sharply between 1984 and 1988 but has since then declined and has stayed consistently lower than US consumer price inflation. As Chart 7 points out the frequent rebasing of the export unit value index has made it difficult to produce meaningful year-on-year price changes using monthly data, rather than the much broader yearly changes shown here. Nonetheless the minor undervaluation of the baht against the USD on a PPP (wholesale price) basis, plus the behaviour of the rate of growth of the export unit value index againt CPI inflation in the US, lead to two conclusions. Firstly, there are no obvious, or quantifiable reasons why the baht should come under sustained pressure. The experience during the May 1992 crisis, an ideal situation for a panic run on the currency, points otherwise. As long as the capital account composition improves, the foreign exchange reserves of Thailand should be more than adequate to withstand any worsening of the current account during the period of recovery in 1993 (see Chart 8). Secondly, the competitiveness of Thai exports as measured by the unit value of exports has not been greatly effected by the high inflation rates of 1989-90. Indeed the falling trend in export price inflation since 1991 indicates otherwise. In other words given the relative stability of the baht-USD exchange rate the movements in the prices of Thai exportable goods are tending towards the movements in the prices of consumer goods in the United States.

Whether the improvement in the trade and current balances will be sustained will depend not only on Thailand's external competitiveness but also on the stage of the business

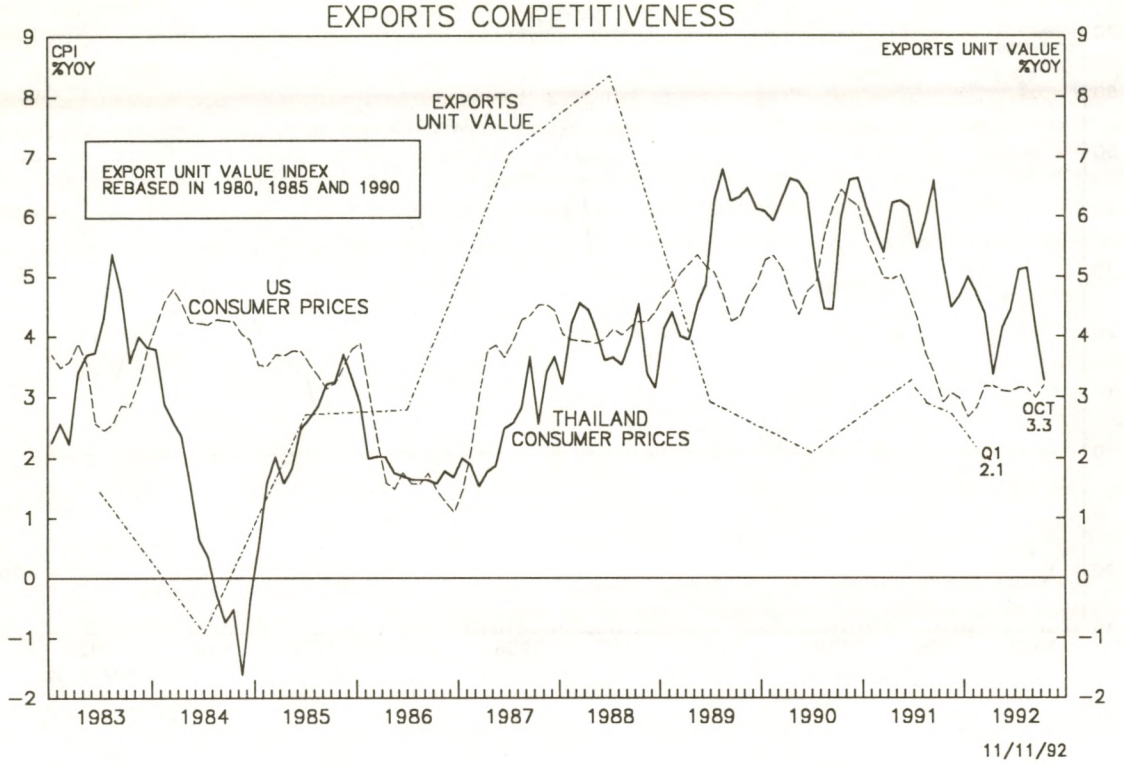
THAILAND: CHART 5
EXPORTS AND IMPORTS GROWTH



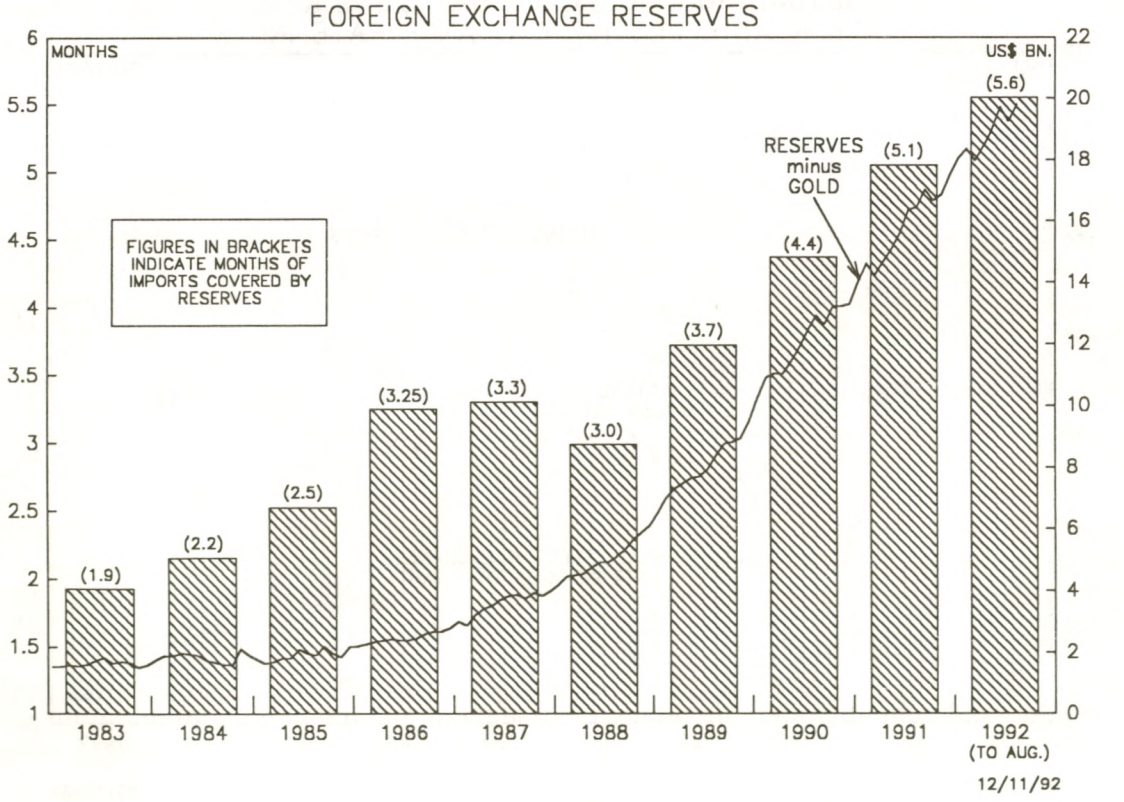
THAILAND: CHART 6
ACTUAL AND PREDICTED BAHT/US$ RATE
AND REAL EFFECTIVE EXCHANGE RATE INDEX



THAILAND: CHART 7
EXPORTS COMPETITIVENESS



THAILAND: CHART 8
FOREIGN EXCHANGE RESERVES



cycle of Thailand's two largest export markets, Japan and US. These two countries account for over 40% of Thailand's exports. Export growth to Japan during 1993 will be at best modest but the situation in the US may prove more encouraging. On the side of invisible receipts, the tourist trade is looking much better, experiencing negative growth since May but having clearly bottomed. The previous year, 1991, proved extremely poor for tourism with Thailand suffering directly the consequences of the Gulf War and of the military coup in February 1991 (Chart 9).

The Real Economy, Fiscal Policy and Credit Growth

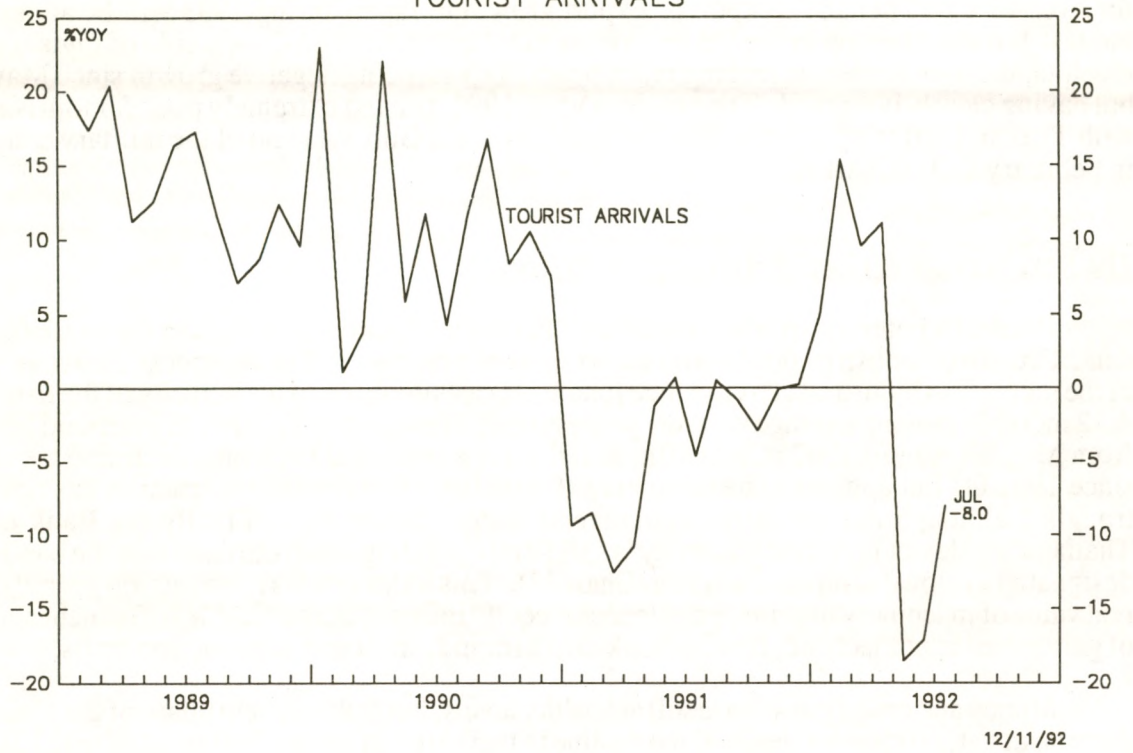
Fears of a potential overheating of the Thai economy are not evident in the available data. Growth of industrial production shows signs of a recovery. The sharpness, however, of the increase in industrial activity since June 1992 casts doubt on to the veracity of the data. A 12 monthly moving average year-on-year estimate shows industrial growth at around 5% from May till August 1992 (Chart 10). Retail sales growth had been on a declining trend since 1991 Q1 but appears to be bottoming (Chart 10). Activity in construction has now troughed although not yet in the commercial sector (Chart 11). Finally the Bank of Thailand's index of investment activity is still firmly pointing southwards within the bands designated as "low" economic activity (Chart 12). This index covers construction permits, real value of machinery imports, private sector equity inflows, domestic sales of cement and of galvanised iron sheet and, finally, bank credit for industrial and construction firms.

Money and credit growth are still at healthy levels, but at the current phase of the cycle there is, as yet, no clear evidence of the decline in their growth having bottomed (Chart 13). The weakness in the economy is likely to keep demand for loans at relatively low levels and hence may put some pressure on bank lending margins. The evidence from lending rates and bank margins is fairly indicative of this situation. Although lending ceiling rates are now irrelevant, banks are still enjoying the widest spread between prime and deposit rates since the end of 1986 (Chart 14).

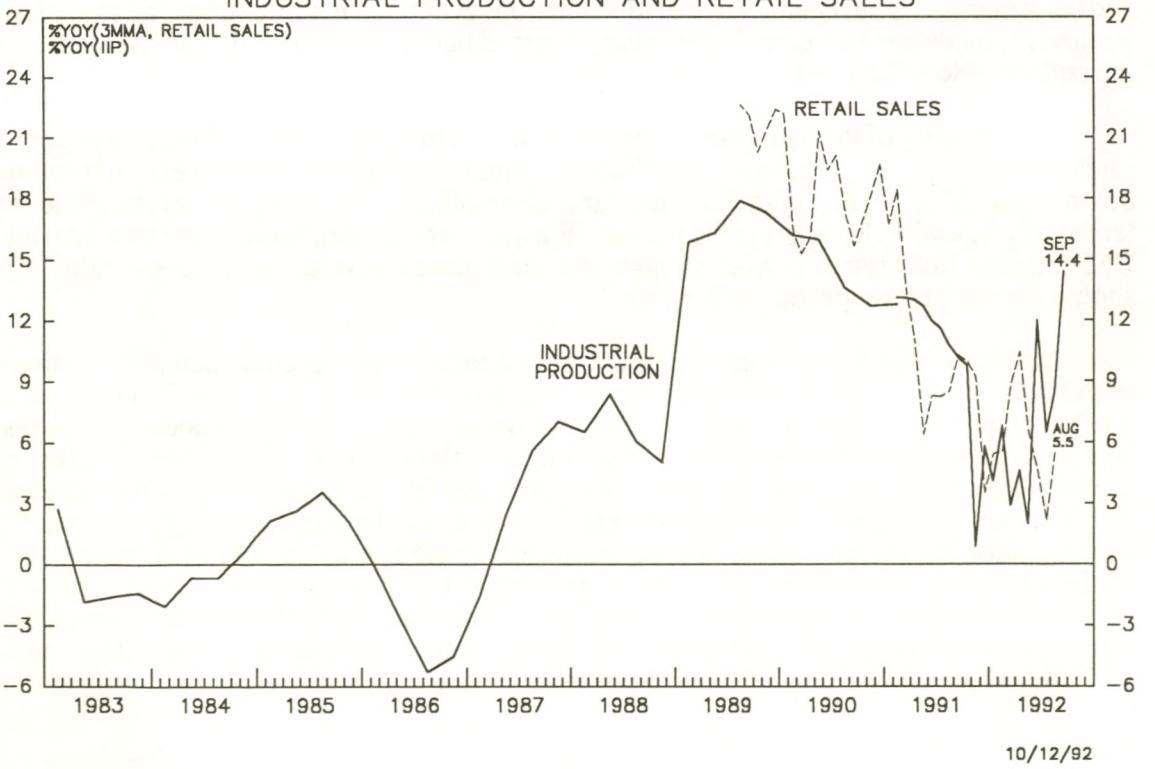
The stability of the baht exchange rate has meant that pressures on short term interest rates are unlikely to appear. As Chart 15 shows, interbank interest rates have been trending down since May 1992, with the June and September 1992 "spikes" explainable by temporary liquidity shortages in the market. Furthermore the differential between Thai and USD interest rates remains wide enough to sustain the relative attractiveness of the baht should any short term pressures develop.

Liquidity conditions are set to ease thanks to a continuous loosening in the fiscal stance of the authorities and the announcement of a budget for 1993 which, for the first time since 1987, will produce a deficit. As Table 1 shows fiscal policy in Thailand became progressively easier since 1991 with the size of the surplus diminishing. The budget surplus for January-July 1992 was 36% less than the surplus for the same period in 1991. Budget surpluses or deficits may have a monetary impact since the surplus signifies either the accumulation of financial assets by the government or the dimunition of its liabilities, such as through the repayment of domestic or external debt. The same reasoning applies to deficits, as they too will involve borrowing (accumulation of liabilities) or dissaving ie the running down of assets. (For a discussion of the mechanics of these processes in the context of Thailand see AMM Vol. 15 No. 3 May-June 1991.)

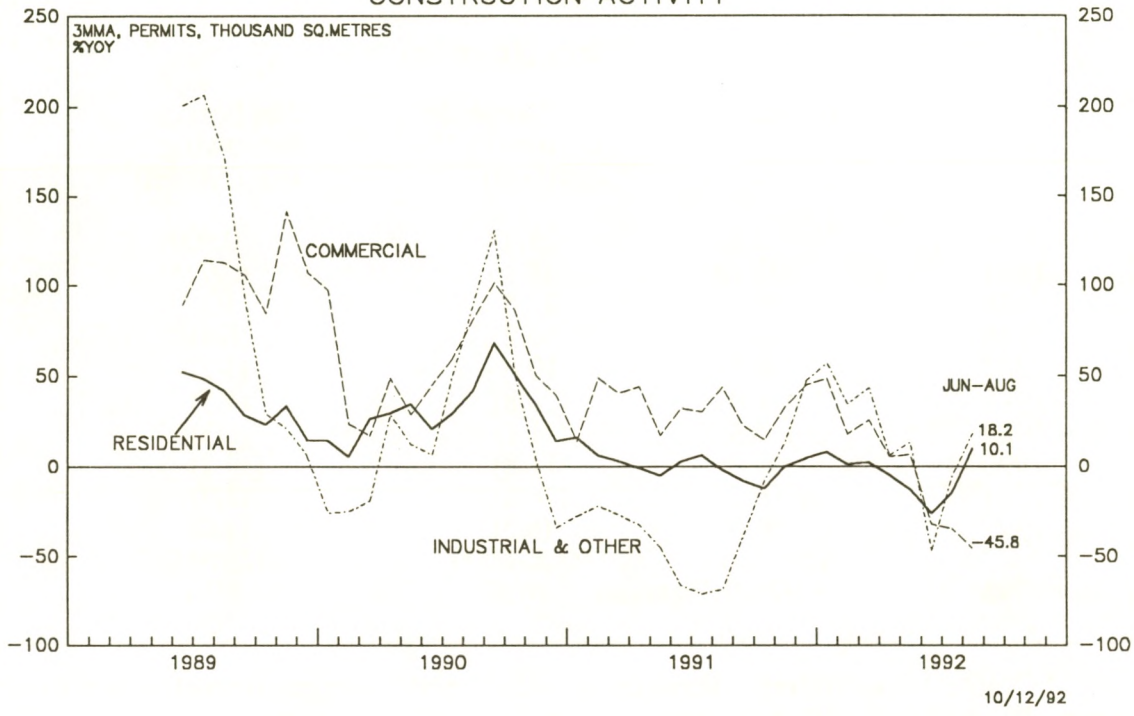
THAILAND: CHART 9
TOURIST ARRIVALS



THAILAND: CHART 10
INDUSTRIAL PRODUCTION AND RETAIL SALES



THAILAND: CHART 11
CONSTRUCTION ACTIVITY



THAILAND: CHART 12
INVESTMENT ACTIVITY

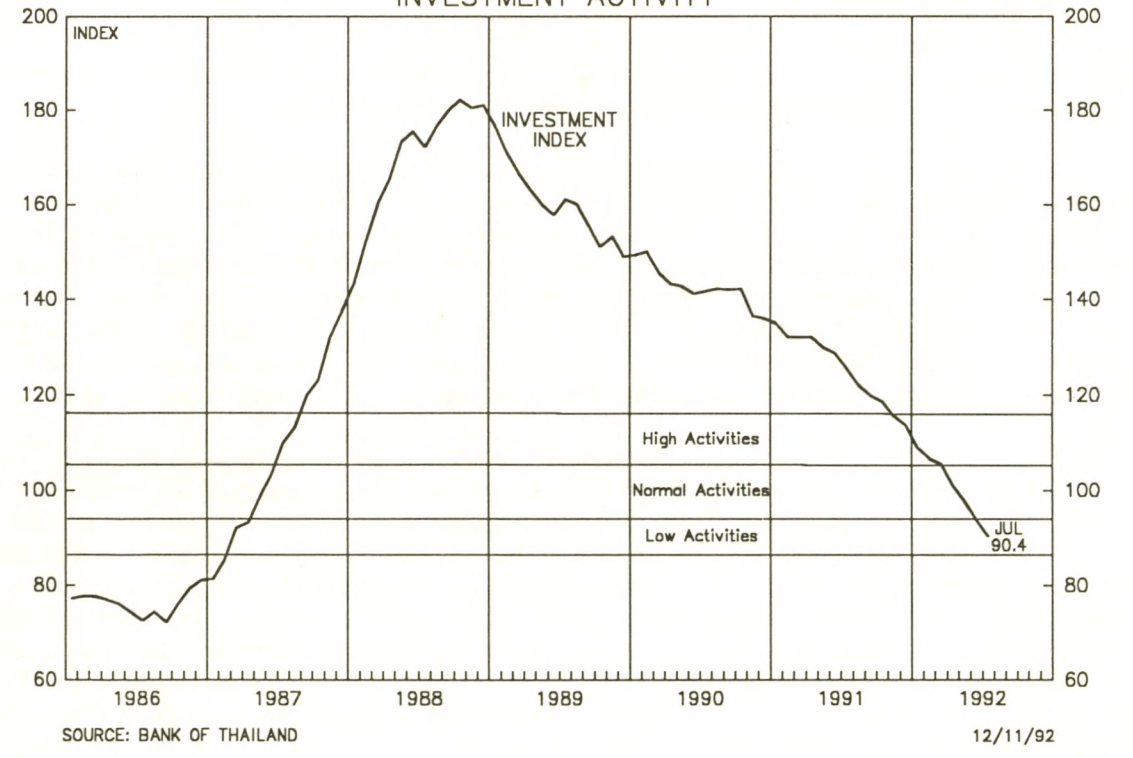


Table 1

Fiscal Balances (Baht bn)

	Budget Deficit (-) or Surplus (+)	Net Domestic Borrowing (Repayment)	Net Foreign Borrowing (Repayment)
1983	-22.82	25.37	0.927
1984	-33.18	35.86	(0.715)
1985	-38.9	31.5	14.1
1986	-34.1	50.2	(6.4)
1987	-8.8	10.6	(3.2)
1988	+36.0	(28.8)	(4.5)
1989	+65.3	(11.1)	(6.1)
1990	-107.0	(11.8)	(39.2)
1991	+100.4	(46.8)	(3.7)
1992	-54.6 (Jan-Jul)	(6.3) (Jan-Mar)	(1.0) (Jan-Mar)
1993	-26.0 (Planned)	N/A	N/A

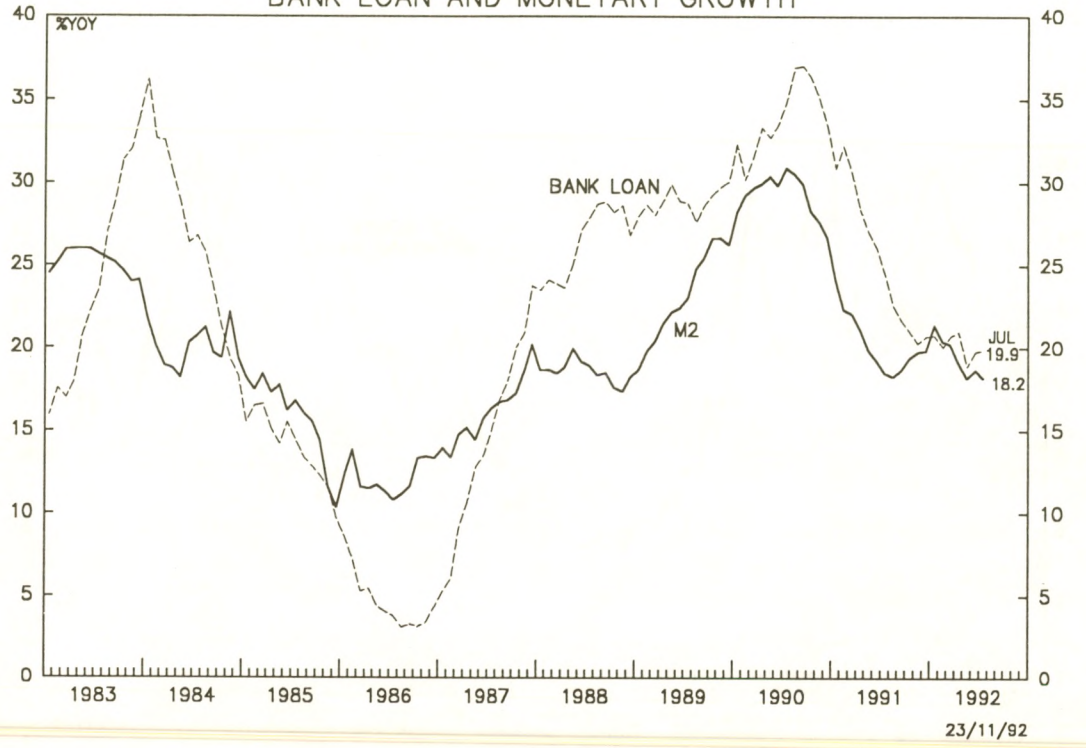
In Table 1 the difference between columns 1 and 2 is approximately equal to the accumulation of cash with the financial system by the state. (The reason for the use of the word "approximate" is that Thai statistics occasionally aggregate with the purely public sector accounts the balances of bodies such as the Farmers Aid Fund and the Oil Fund).

If the state accumulates balances with the banking sector, there is no effect on the money stock growth unless there are different reserve requirements for these deposits. If the state, however, accumulates balances with the central bank there is a direct impact on the monetary base as state deposits are excluded from that definition.

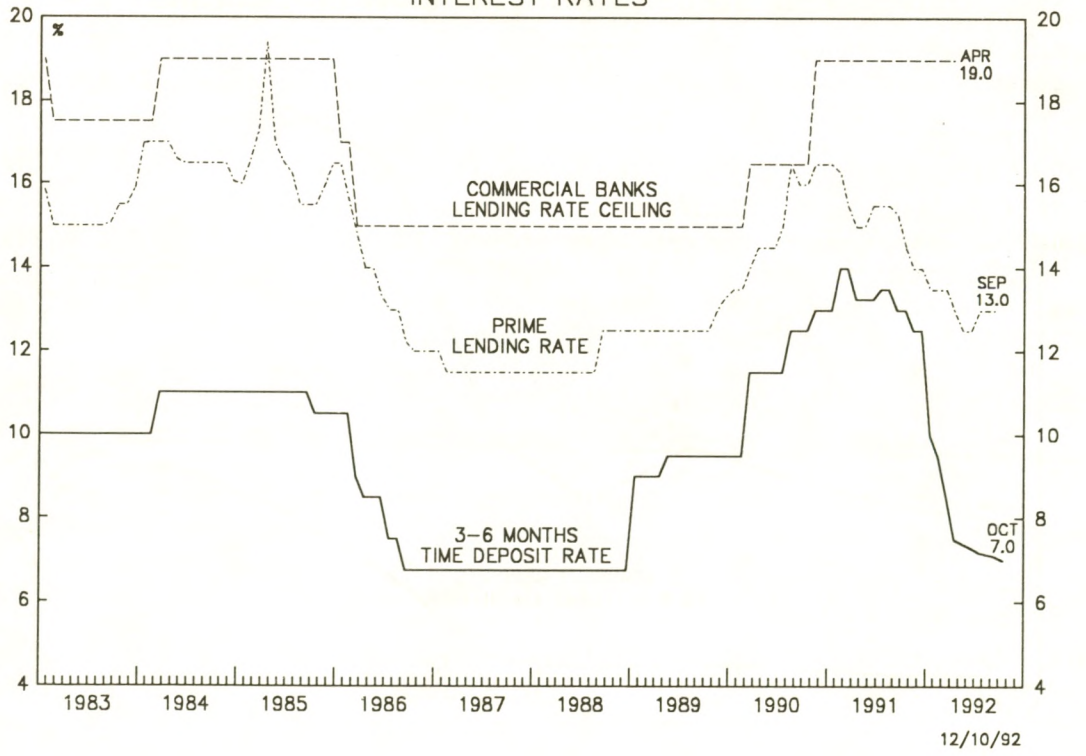
As Chart 16 shows, the share of state deposits to total deposits or liabilities with the Bank of Thailand rose very sharply from 1988 onwards as the budget switched from deficit to surplus. Since 1991, however, this rise has stabilised, and as the 1993 budget will be in deficit, the share of state deposits can be expected to fall. The share of state deposits to total commercial bank deposits has been quite small and has been kept, subject to limited variations, around the 3% mark (Chart 17). Over time the state has used part of the budget surplus to repay government bonds. This has meant that bonds account now for a considerably smaller percentage of assets of both the central and of commercial banks (Chart 18).

Chart 19 shows that the proportion of foreign assets to total assets of the central bank increased quite sharply as from 1988, the same year that the budget switched into surplus. Since 1991 that proportion has remained high but stable. One interpretation is that the acceleration in the accumulation of foreign exchange reserves reflecting capital inflows since 1988 (Chart 3) was partially sterilised through the fiscal surplus. If a central bank wishes to neutralise the impact of capital inflows on the domestic money stock it can do so by selling government bonds to banks or to the public. The Thai authorities did the equivalent here by accumulating balances with the central bank. As fiscal policy became progressively looser from 1990 onwards and capital inflows slowed down, the purely

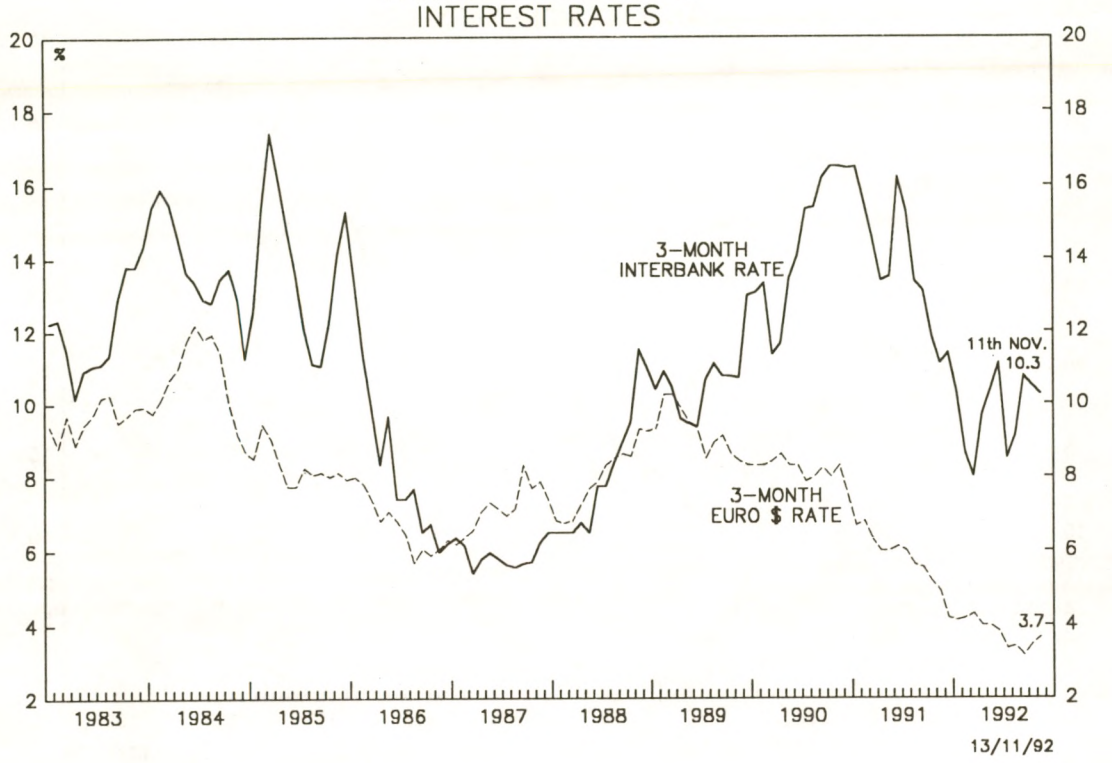
THAILAND: CHART 13
BANK LOAN AND MONETARY GROWTH



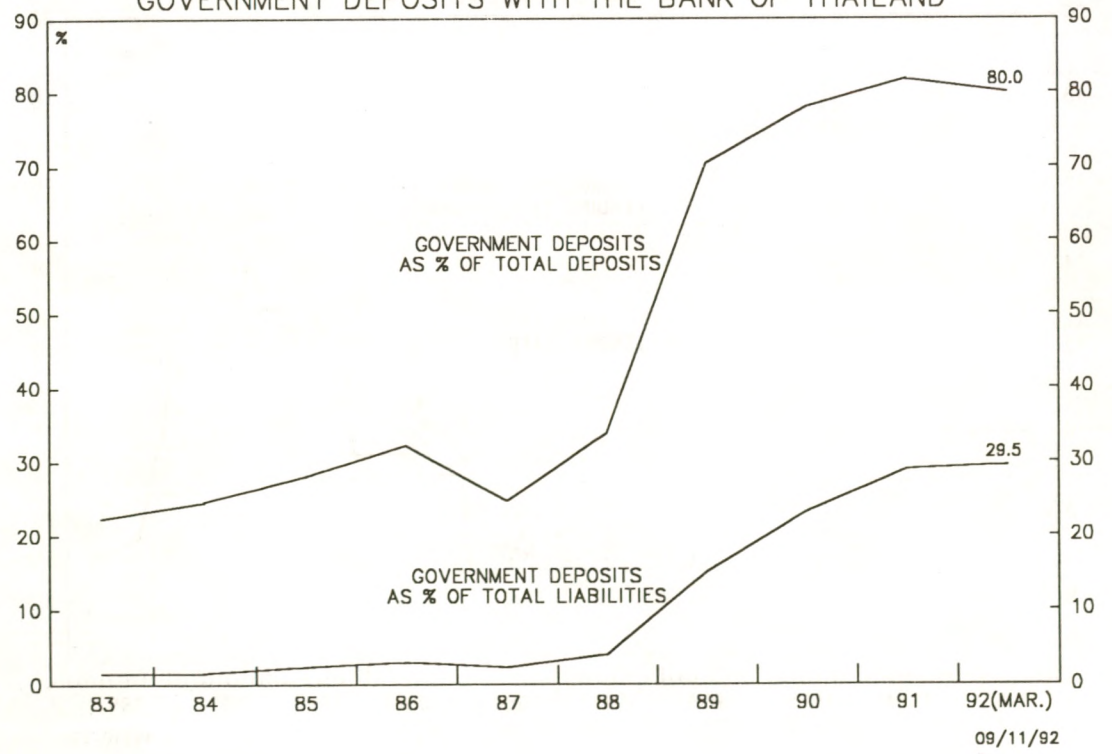
THAILAND: CHART 14
INTEREST RATES



THAILAND: CHART 15
INTEREST RATES

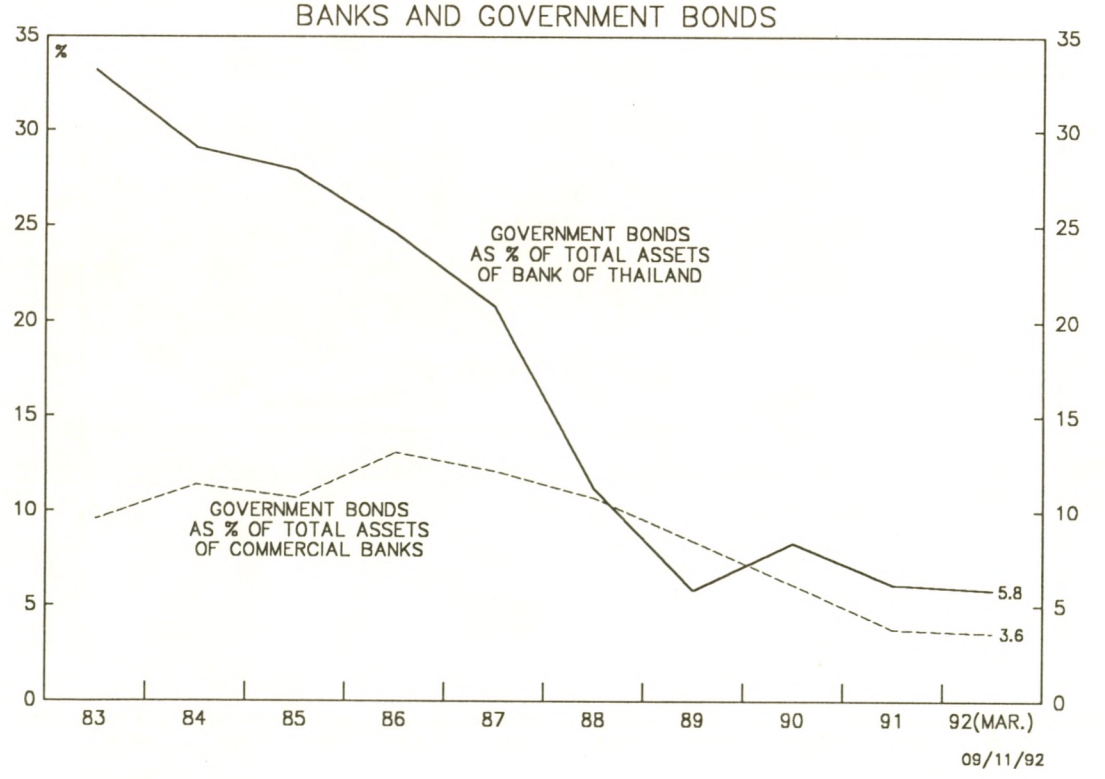


THAILAND: CHART 16
GOVERNMENT DEPOSITS WITH THE BANK OF THAILAND

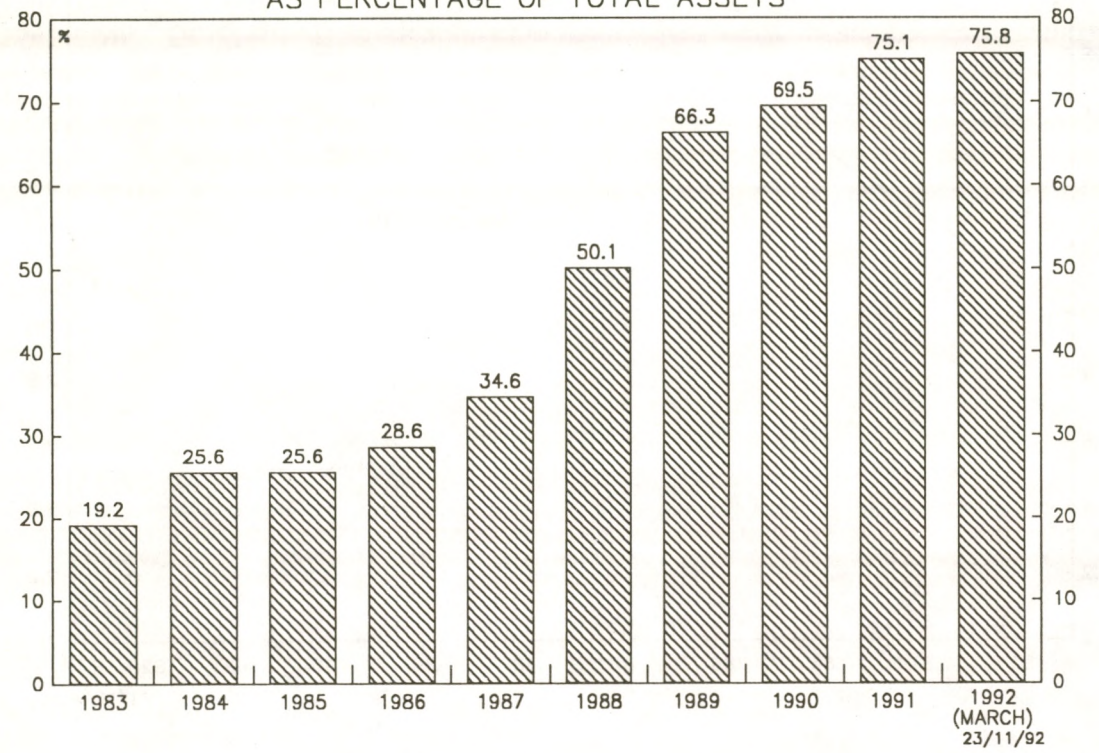


THAILAND: CHART 17
GOVERNMENT DEPOSITS WITH COMMERCIAL BANKS

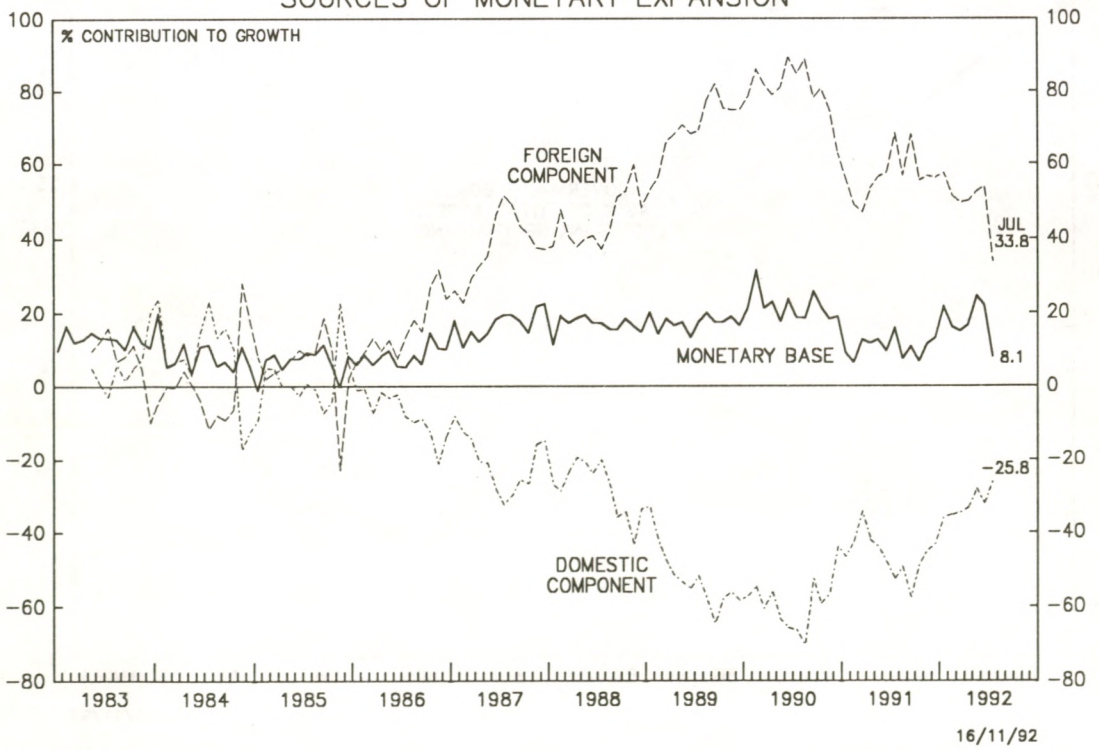
THAILAND: CHART 18
BANKS AND GOVERNMENT BONDS



THAILAND: CHART 19
FOREIGN ASSETS OF BANK OF THAILAND
AS PERCENTAGE OF TOTAL ASSETS



THAILAND: CHART 20
SOURCES OF MONETARY EXPANSION



domestic impact of fiscal policies on the monetary system became more pronounced.

The impact of this progressively looser fiscal policy can be seen more clearly through the contribution of domestic credit components to the monetary base (Chart 20). Since 1990 Q4 the domestic component has been rising whilst the foreign component fell to 1991 Q1 and then remained relatively stable. (The sharp decreases during July 1992 in the growth of the monetary base and the contribution of the foreign component are based on provisional data and may not reflect a break in the trend.) The fact that the domestic component makes a negative contribution to the growth of the monetary base, needs some explanation. The positive contribution comes from external inflows of capital which, given the exchange rate policy of Thailand of keeping the baht virtually pegged against the USD, will impact directly the monetary base unless they are sterilised. The negative contribution of the domestic part indicates primarily the role of the accumulation of government deposits with the central bank. As the budget surplus became progressively smaller, and this was reflected in the balances of the state with the central bank (see Chart 16), its negative contribution to the monetary base also became smaller. In other words the monetary base would have expanded much faster since 1988 had it not been for the restraining influence of the budget surplus. As this surplus is scheduled to become a deficit during 1993, given the external flows, the monetary base can be expected to continue to grow and possibly to accelerate.

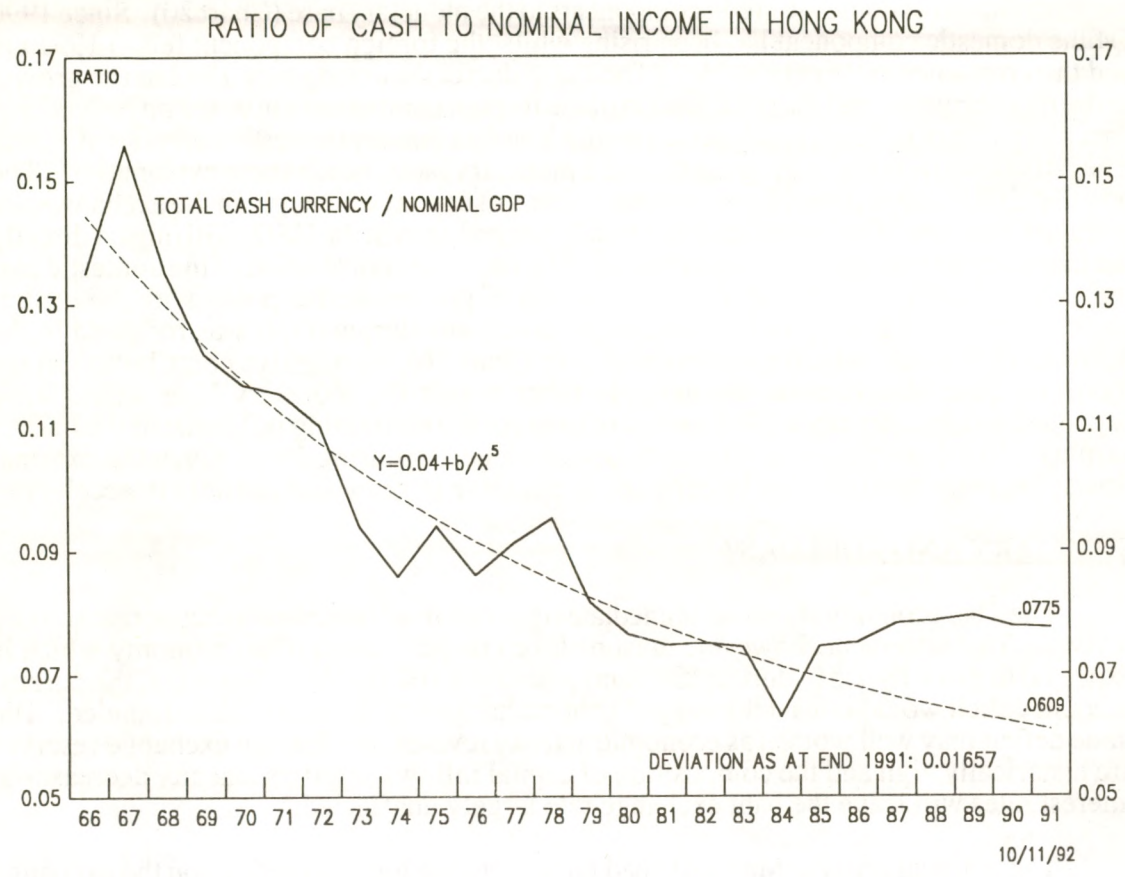
SUMMARY AND FORECAST

The Thai economy shows no immediate signs that it will overheat as economic activity revives. This statement, however, must be taken in the context of an economy which is expected to grow by 7.5% during 1992 and possibly 8.0% in 1993. Fears that the current account deficit would impact the pegged baht exchange rate have proven unfounded. The trade deficit may well worsen as economic activity revives, but foreign exchange reserves are historically high and the composition of capital inflows signifies that any decreases in interest rates will leave the baht exchange rate largely unaffected.

The political crisis in May 1992 had no perceptible long term effect on the exchange or interest rates. The liquidity conditions of the economy will not prove a constraint on recovery.

As indicated at the opening paragraphs of this article the definition of what constitutes a "soft landing" can be vague or flexible. In the case of Thailand, in the present circumstances, a soft landing does signify that the economy avoided a balance of payments and/or exchange rate crisis without necessitating very restrictive monetary or fiscal policies. Given the looser fiscal stance for 1993, the liquidity conditions are at present indicating that the reviving economy will not bring to bear any immediate pressure on interest rates. It now follows that the environment for equities will become progressively more promising as liquidity continues to improve and interest rates ease.

HK$ CURRENCY IN SOUTHERN CHINA - AN UPDATED ESTIMATE



In AMM Vol. 14 No. 4, we offered an estimate of the amount of HK$ currency circulating in Guangdong province. This capsule updates our model to the end of 1991 and discusses briefly what this HK$ pool implies for monetary management in Hong Kong and in China.

Our methodology assumes that the growing interdependence of the Hong Kong and Guangdong economies has caused an upward shift in Hong Kong's cash currency-to-income ratio in line with increased demand for HK$ in southern China. Observation suggests that this shift began around 1985, so we have fitted a curve of the form $Y = a + b/x^5$ to the data over 1966-84, and extrapolated the curve forward over 1985-91. The deviation between the actual and the fitted line at the end of 1991 is 1.66% which given a nominal GDP of HK$634.5 billion, implies that HK$10.5 billion of currency (or 21% of the total issue) is circulating outside of the territory. In addition, we estimate that HK$2.0 billion of currency is circulating in Macau based on an assumption that the HK$/Patacas currency ratio is the same as the ratio of HK$/Patacas demand deposits. This ratio had risen from 1.6 in 1989 to 2.3 at the end of 1991 after being relatively stable in previous years. A case can therefore be made for subtracting (1-1.6/2.3) x 2.0 = HK$0.6 billion from our southern China estimate, but this does not change the results significantly. Moreover, the Macau-Guangdong border is if anything even leakier than that in Hong Kong, and a fair portion of this currency could well have come via China in any case. The results are summarised in Table 1.

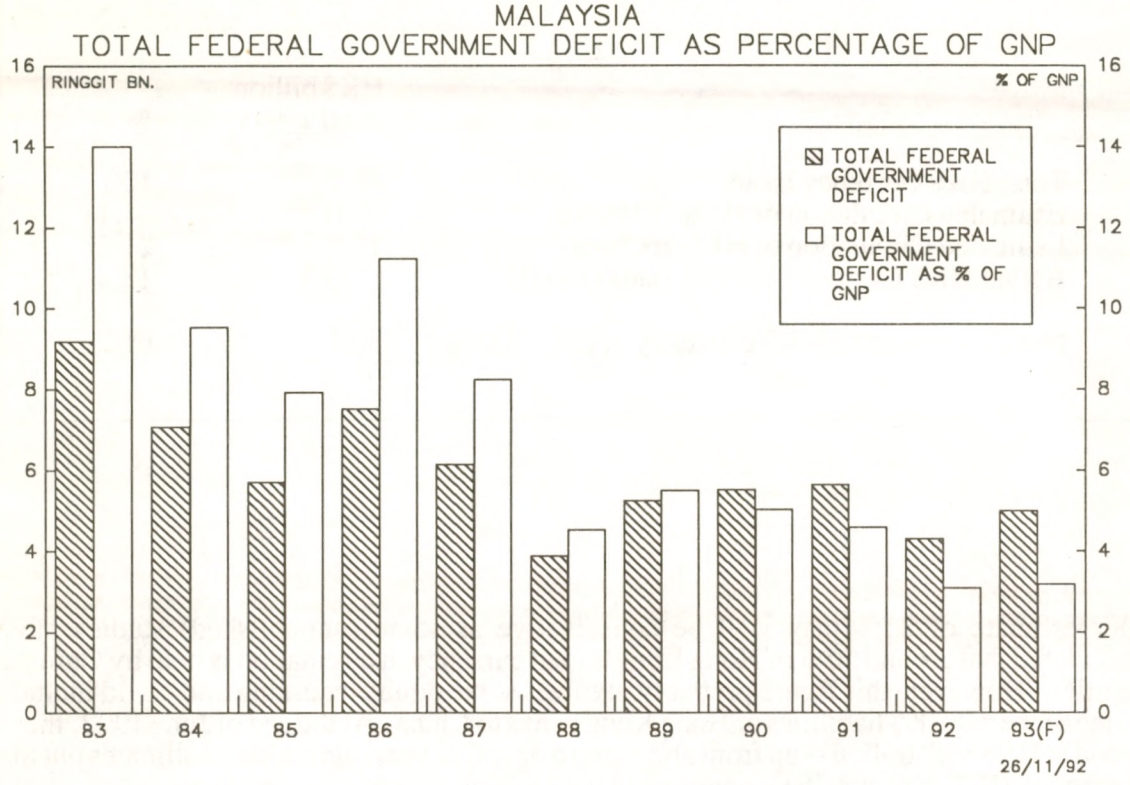
Table 1

	HK$ billion (End 1991)	%
Total HK$ Currency Issue	49.2	100
Estimated Circulation of HK$ in Macau	2.0	4.1
Estimated Circulation of HK$ in China	10.5	21.3
Actual HK$ Currency held by Banks in HK	6.6	13.4
Net Circulation of HK$ Currency in Hong Kong	30.1	61.2

Our estimate of 21% may well be conservative as some (unpublished) studies have calculated that around 50% of Hong Kong's total currency in circulation is held by Chinese entities. However, this figure probably involves some double counting and could include some of the net HK$ liabilities of Hong Kong banks to China. At the end of June 1992, these stood at HK$56.7 billion -- up from almost zero only five years ago. Other estimates put the figure for HK$ currency in Guangdong in the 15-20% range.

Some people have expressed cautious concern that this pool of currency could undermine the Hong Kong authorities' conduct of monetary policy. Leaving aside the fact that Hong Kong's money creation is a function of its balance of payments flows, HK$10.5 billion pouring back into Hong Kong in one lump would, in theory, boost effective HK$M2 by 1.8% and HK$M3 by 1.7% (actual M2 and M3 are of course unchanged). In practice the chance of such an occurence is virtually nil. HK$ are held in southern China in part to facilitate trade, investment, tourism and family transfers, and in part as a hedge against inflation in the mainland. It would require the severence of all contacts plus the availability of sufficient alternative assets to precipitate such a return flow. HK$ currency in Guangdong, if it is being widely used as a transaction currency, does however, reduce the control of the Beijing authorities. (In fact, outside of Shenzhen it is rare to find HK$ transactions between locals; most HK$ currency is held as an inflation hedge and thus as a passive asset.)This is well recognised and is one of the driving forces behind their development of asset markets. By encouraging people to invest in stocks, bonds and property, and by allowing individuals to hold foreign currency accounts, Beijing is attracting funds (both foreign currency and domestic) back into the banking system. Nevertheless, financial sector reform is proceeding only slowly and in the interim, the authorities' control over aggregate holdings of monetary assets -- especially in Guangdong -- will continue to diminish.

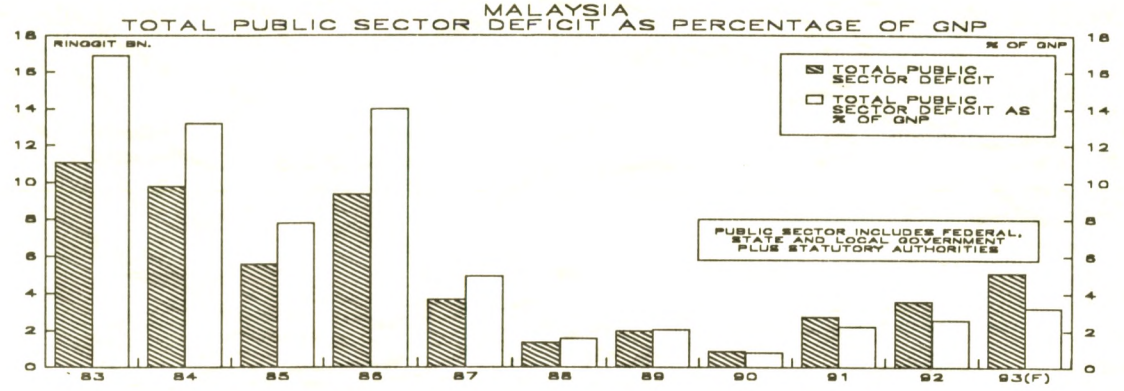
MALAYSIA: AN AMBIVALENT FISCAL STANCE

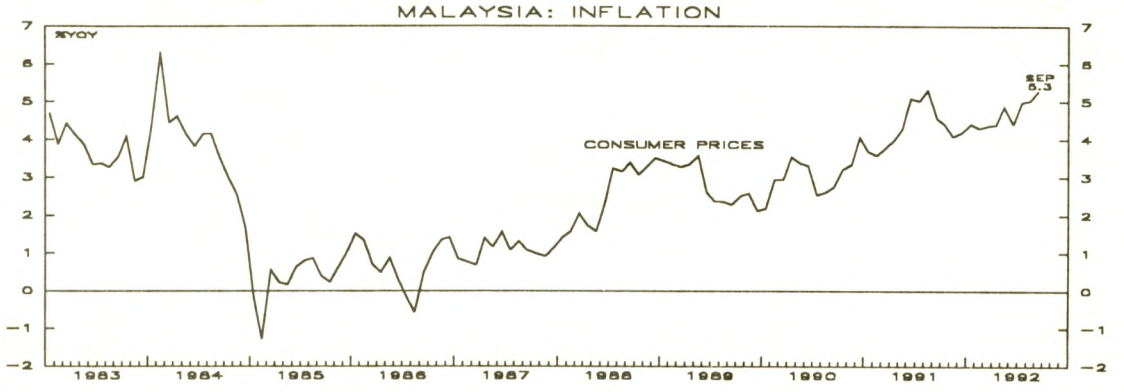


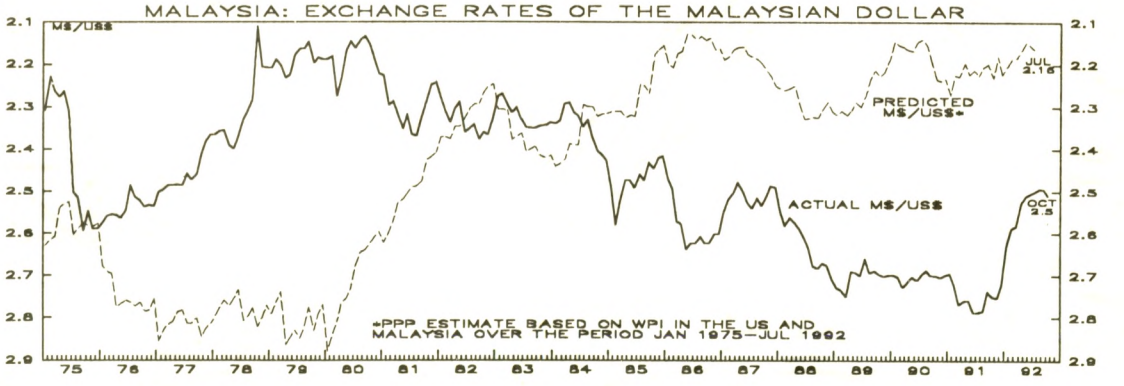
The October 1992 budget has been misleadingly called the "one percent" budget. The headline-catching tax changes involved a one percent drop in the corporate tax rate, a 1-2% reduction in income tax rates and a one percent increase in the contributions by both employees and employers to the Employees Provident Fund. There were further adjustments in indirect taxes and decreases in import duties over a wide range of goods. Total government spending which includes development (i.e. capital) expenditures is expected to drop to M$44.1 bn in 1993 from approximately M$48.0 bn allocated in 1992. The actual 1992 expenditures were smaller than the allocated ones and hence, on a purely nominal percentage basis, the reduction in the proposed nominal expenditures for 1993 are less than the 8% which appeared on the budget.

Taking the federal government alone, the budget has a mildly expansionary impact because, as the chart above shows, both the deficit in money terms and as percentage of GNP are to grow during 1993. The whole public sector however is also due to expand with the deficit rising in absolute and GNP percentage terms (top chart opposite page). Considering the total public sector, however, may be misleading as this includes capital expenditures of quasi-public bodies such as the electricity and telephone utilities which are now partially privatised.

The relatively easier fiscal stance will not sit well with a still rising inflation (second chart opposite page), an undervalued ringgit (third chart opposite) and an improving balance of payments which will increase revaluation pressures. The prospects of falling interest rates, if the authorities still wish to cap the appreciation of the ringgit, augur well for equities but poorly for inflation.


MALAYSIA
TOTAL PUBLIC SECTOR DEFICIT AS PERCENTAGE OF GNP
RINGGIT BN.
% OF GNP
TOTAL PUBLIC SECTOR DEFICIT
TOTAL PUBLIC SECTOR DEFICIT AS % OF GNP
PUBLIC SECTOR INCLUDES FEDERAL, STATE AND LOCAL GOVERNMENT PLUS STATUTORY AUTHORITIES
83
84
85
86
87
88
89
90
91
92
93(F)


MALAYSIA: INFLATION
%YOY
CONSUMER PRICES
SEP 5.3
1983
1984
1985
1986
1987
1988
1989
1990
1991
1992


MALAYSIA: EXCHANGE RATES OF THE MALAYSIAN DOLLAR
M$/US$
PREDICTED M$/US$*
JUL 2.16
ACTUAL M$/US$
OCT 2.5
*PPP ESTIMATE BASED ON WPI IN THE US AND MALAYSIA OVER THE PERIOD JAN 1975–JUL 1992
75
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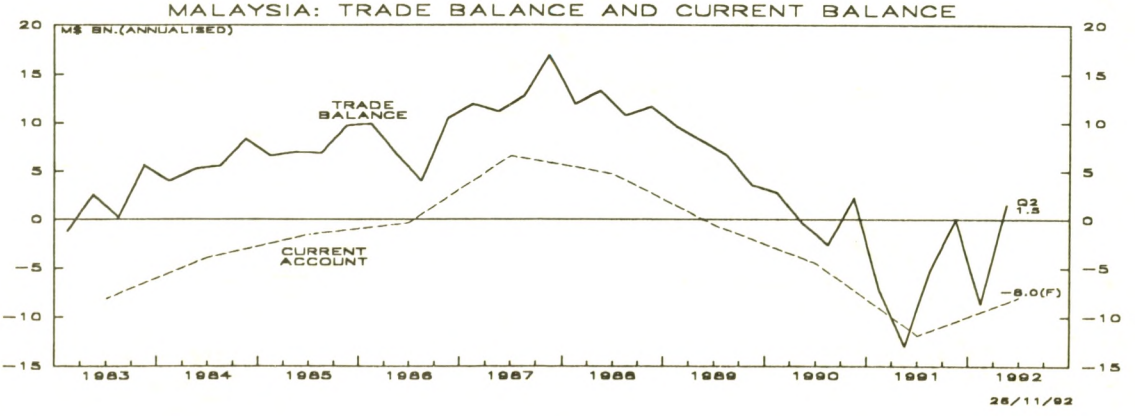
92


MALAYSIA: TRADE BALANCE AND CURRENT BALANCE
M$ BN.(ANNUALISED)
TRADE BALANCE
CURRENT ACCOUNT
Q2 1.5
-8.0(F)
1983
1984
1985
1986
1987
1988
1989
1990
1991
1992
25/11/92